

# THE TAXATION OF SMALL INCOMES

SOCIAL, REVENUE, AND ADMINISTRATIVE  
ASPECTS

*By*

PAUL JOHNSTON STRAYER, M.A.

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE  
DEGREE OF DOCTOR OF PHILOSOPHY, IN THE FACULTY OF  
POLITICAL SCIENCE, COLUMBIA UNIVERSITY

THE RONALD PRESS COMPANY  
NEW YORK

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## PREFACE

It is generally accepted that the past decade has been one of the most unsettled in the peace-time history of this country. The rise in the public debt and the increase in the tax burden have been particularly disturbing to the general public because of the sharp contrast to the period of financial prosperity and debt reduction which characterized the previous decade. Another source of confusion has been the development of new monetary and debt policies by the federal government. The old maxims of thrift and economy still have the support of the average citizen, yet the government expert will often tell him that the difficulties of the present day are the result of too much saving and too little spending.

Responsibility for many of the new developments rests in the hands of a group of economists who are in the process of reconsideration of most of the generally accepted doctrines of finance and are endeavoring to adjust their thinking to new depression conditions. Up to the present time, most of their effort has been applied to monetary issues. The problems of taxation have been less thoroughly studied and, with a few notable exceptions, less critical minds have devoted their attention to them. Unfortunately, this is not because the need is less pressing. With the scope of governmental activity greatly expanded, there is little reason to expect any large reduction in the level of expenditures. The failure to readjust the tax system to these new conditions has led to the continued deficits and to a great many inequities in the distribution of burden. It is suggested, therefore, that it will be possible to restore financial confidence only if there is a fundamental revision of the tax system with the emphasis placed on present conditions rather than on the past.

It is the purpose of this book to deal critically and thoroughly with one aspect of the general problem of taxation, the problem of the taxation of small incomes. In the development of the analysis, it has been found to be necessary to reconsider the aims or

goals which are the basis for the determination of actual policy. In these days of financial stringency, it was also thought necessary to consider the revenue-producing capacity of income recipients at levels below those now exempt from federal personal income tax. In addition, because of the many suggestions that the broadening of the income tax base would improve citizenship, the question of the relation of taxation and awareness of taxation to political activity has been reconsidered. Finally, as it is impossible to speculate about modification of the tax system without considering the questions of administrative practicability and costs of collection, a large portion of the book is devoted to an effort to anticipate some of the major problems of this type which will arise with a change in the treatment of the small income recipient. In this part of the book, an extensive discussion of the Australian, British, and German administration of the income tax in the lower brackets is undertaken not only because they have had years of experience in this type of taxation, but also because there is much to be learned from them, even if there is no modification of the exemption level in this country.

This book is frankly concerned with policy formation. In it the writer has arrived at conclusions and treated materials in a manner which is to be explained, in part, as the result of his own biases and convictions. This is believed to be inevitable in the study of taxation. However, a conscientious effort has been made throughout to present these biases and convictions explicitly. In view of the inadequacies of the available material and the shallowness of a large part of the popular discussion of the issues involved, it is hoped that this book will raise the level of the discussion. In a democracy, each person should make up his own mind on current issues. The most difficult accomplishment is the provision of an adequate understanding of the issues involved in a complex question of this type. To accomplish this purpose, an effort has been made to develop the argument in a manner which an intelligently interested person without economic training can understand.

For their assistance and cooperation in the provision of information about the personal income tax in their respective



states, the author is deeply indebted to W. M. Bates and V. H. Coombs of the State Tax Commission of the State of Utah; C. M. Beem of the Iowa State Board of Assessment and Review; Ellis B. Bever, Director, Income Tax Department, State Tax Commission, Kansas; W. R. Bland, Assistant Director, Income Tax Division, Arizona State Tax Commission; W. R. Bradley, Director, Income Tax Division, South Carolina Tax Commission; L. C. Burns, Supervisor, Income Tax Department, Montana; L. D. Shellworth, Director, Department of Income Tax, Idaho; William H. Stauffer, Economist, Department of Taxation, Virginia; Leigh Watkins, Jr., Director of Research, State Tax Commission, Mississippi; and H. Isaiah Smith, Director of the Budget, State of West Virginia.

For their courtesy and assistance in making it possible to gain an understanding of the British tax administration, the writer is indebted to G. B. Canny, C.B., Deputy Chairman of the Board of Inland Revenue; E. Atkinson, District Inspector of Taxes, Waterloo District; A. W. Baldwin, Senior Inspector of Taxes; A. L. Beck, Statistics and Intelligence Department, Board of Inland Revenue; C. J. Gregg, Secretary of the Board of Inland Revenue; and S. J. Wood, Principal Inspector of Taxes.

To Georg Dobriner the author is most grateful for his assistance in the gathering and development of the material on German income taxation. Thanks are also due C. Lowell Harriss for his kindness in reading the manuscript before final revision for the press. To Miss Ethel Spore, who typed the manuscript, the author is indebted for her patience, skill, and editorial assistance.

For their encouragement in the undertaking of this book and their helpful criticism and suggestions at all stages of development, the author wishes to indicate most of all his gratitude to Professors Robert Murray Haig and Carl Shoup of Columbia University. For the opinions expressed and for omissions or errors, the author alone is responsible.

PAUL J. STRAYER

Princeton, N. J.,  
August, 1939.



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THE TAXATION OF  
SMALL INCOMES





# CHAPTER 1

## INTRODUCTION

For various reasons the more extensive use of the personal income tax is being widely advocated. There is a general belief that the first move should be a lowering of the exemptions to increase the percentage of the population within the scope of the tax. It is the purpose of this study to analyze the case for and against this taxation of small incomes.

Unfortunately, none of the advocates of the various specific proposals has done much more than simply state he believes lower exemptions to be desirable.<sup>1</sup> In a few cases scanty supporting evidence is presented, but no one has adequately explored the implications of such a change. Often the case for the taxation of small incomes is based upon the uncritical belief that it will develop a sense of political responsibility through an increase in tax consciousness. A lack of tax consciousness, a connection between tax consciousness and good citizenship, and the effectiveness of the suggested remedy are taken for granted. The possible objections to the plan receive only meager attention. As often happens in the field of public finance, the proposal receives support from groups which believe it will tend to achieve fiscal aims diametrically opposed; those who favor larger governmental expenditure desire an income tax with a broad base as a measure for improving the distribution of the tax burden, thus rendering more feasible and acceptable an increase in its size in the aggregate, while those who favor retrenchment advocate the change simply because they believe it will generate tax consciousness, which in turn will reduce public spending or prevent its increase.

An adequate analysis of the taxation of small incomes should include, first, an appraisal of the merit or lack of merit of the

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<sup>1</sup> Specific proposals are quoted extensively in the latter part of the study and subjected to critical analysis.

measure considered by itself; second, a critical comparison of the proposal with possible alternatives; and, third, an estimate of the effects of such a change upon the existing tax system, federal, state, and local. A critical appraisal of this nature implies some ideal tax system which may serve as a basis for comparison. That this ideal tax system is never achieved and that various persons conceive of different ideal tax systems is an observation that must impress anyone acquainted with the conflicts of opinion and disputes found in the writings of tax experts and others interested in the problems of public finance.<sup>2</sup>

Since the publication of Adam Smith's *The Wealth of Nations* in 1776, the attributes of a good tax system have been discussed by most writers in the field of public finance. Lists of maxims, canons, principles, or aims of taxation have been made by practically all the important writers and have afforded the basis for lengthy disputes among those favoring different policies. The result of this controversy has been, in some cases, to raise the level of discussion above that resulting from the lobbying of groups with special interests. It has also served the useful purpose of defining the issues, though there remains, of course, some dispute as to the ground that may be included within the field of public finance.

The differences of opinion upon the aims generally accepted are, for the most part, of two kinds. First, there are differences as to the way in which some canon, aim, or principle is to be realized. For example, practically all tax authorities agree that justice or equity is an important goal, yet few agree as to the specific measures to be used in seeking justice. In the second place, there are differences of opinion among tax experts as to the relative importance of the various aims. One individual may consider justice so important that he would be willing to make almost any sacrifice to achieve it. On the other hand, another person may consider administrative efficiency so important that he would be satisfied with a very rough and ready form of

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<sup>2</sup> Blough, J. Roy, "Model Tax Systems and Tax Reform," *The Bulletin of the National Tax Association*, Vol. XV, No. 5, February 1935, pp. 130-134, *passim*.

justice. The conflict is made clearly apparent in the following quotation from T. S. Adams:

Taxes are as complex as life. The moralist calls for just taxes, but taxes cannot just be just. The administrator asks for simple taxes; but experience shows that they cannot simply be simple. Some politicians would mould taxes wholly in accordance with political expediency; but statesmen realize that in the long run this would be impolitic. The business man demands practical taxes, but financial history proves that it is impracticable to make them merely practical. The legalist wants taxes administered strictly according to law; but the record of the income tax and the property tax makes it clear that such taxes cannot be successfully administered by methods meticulously legal.<sup>3</sup>

A review of the basic principles of taxation as stated by the best-known writers reveals that there has been substantial uniformity in their broad conception of the fundamental principles. To the familiar lists of canons and maxims based upon Adam Smith's classic injunctions specifying equality, certainty, convenience, and economy, the later more elaborate catalogs of Ricardo, Mill, Bastable, Wagner, and Seligman have added little that could not be read into the statements of Adam Smith.<sup>4</sup> There is, however, one recent development that is of particular importance in this study. It is the inclusion of the politically significant concept of tax consciousness or conscious citizenship as one of the attributes of a good tax system. This is by no means accepted by all modern writers, and the continued reliance of political jurisdictions upon indirect or hidden taxation indicates that the concept is considered either undesirable or unworkable by the legislators responsible for the tax program. It

<sup>3</sup> Adams, T. S., "Ideals and Idealism in Taxation," *The American Economic Review*, Vol. XVIII, No. 1, March 1928, p. 5. See also Weston, Stephen F., *Principles of Justice in Taxation*, New York, 1903, pp. 11, 13.

<sup>4</sup> Smith, Adam, *The Wealth of Nations*, Book V, Ch. II, Part ii (The Modern Library edition), New York, 1937, pp. 777-779. Ricardo, David, *Principles of Political Economy* (Everyman's edition), Ch. XII, pp. 115-116. Mill, John Stuart, *Principles of Political Economy* (Ashley edition), Book V, Ch. II, pp. 802-803. Bastable, C. F., *Public Finance* (3rd edition), London, 1903, Book III, Ch. VII, pp. 417-420. For a general discussion of the objectives proposed by the various writers, especially Seligman, see Haig, Robert Murray, "Taxation," *Encyclopaedia of the Social Sciences*, Vol. XIV, New York, 1934, pp. 538-539.

does, however, appear to be of growing importance. Accepted by Robert Jones<sup>5</sup> as one of the six basic principles of taxation, and more recently by the research directors and the special committee sponsoring the tax survey, *Facing the Tax Problem*,<sup>6</sup> as one of the secondary aims of taxation, it is at least a point which can no longer be neglected. Though earlier writers were concerned with the relation of tax obligation to participation in political decisions in a democracy, there was not the same emphasis placed upon the type of tax imposed.

In view of the fact that there is substantial agreement among the authorities with respect to the more general attributes of a good tax system, it is believed that the most profitable analysis of the present problem will be made if it is developed around these commonly accepted aims or first principles of taxation. An effort will be made to present the maximum amount of factual data bearing on each issue before there is any evaluation of the facts presented and the formation of definite conclusions. However, no attempt will be made to maintain complete objectivity, as it is believed that in many cases an expression of value judgments is both desirable and unavoidable, even in the preliminary stages of the analysis of a problem of this type.

In the selection of the general aims to serve as a framework for this study, an effort has been made to include all points considered important by students of the tax problem. Four main divisions will be made. Each will receive separate treatment in a single chapter, the more detailed points being taken up within the broad bounds of the chapter.

First, it is important to know the fiscal implications of lower bracket income taxation. To obtain revenues to meet the needs of government is one of the primary purposes of taxation. Some taxes will supply very large amounts of money while others may be so restricted in scope that, regardless of the rates imposed or other limiting factors such as administrative practicability or justice, their yield will be small. For example, though

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<sup>5</sup> Jones, Robert, *Taxation Yesterday and To-Morrow*, London, 1921, p. 73.

<sup>6</sup> *Facing the Tax Problem*, a report prepared under the auspices of the Committee on Taxation of the Twentieth Century Fund, Inc., Carl Shoup, Research Director; Roy Blough, Mabel Newcomer, Associate Directors; New York, 1937, p. 53.

the federal government for a time placed a tax on private yachts, the yield of this tax could not be large because of the small part of the national income paid out for such purposes. On the other hand, other things being equal, it is possible to conceive of a general income tax with a rate scale sufficiently severe to supply the total revenue demands of the government. Productivity is an essential of all but purely regulatory taxes. There is no chance of replacing a "bad" tax with a "good" tax unless it is certain that the "good" tax will raise the same amount of revenue lost by the repeal of the "bad" tax.

Other points of fiscal importance are the relative stability of revenue and the elasticity or responsiveness of the tax to changing needs.

The problems to be considered in the second division are of a social or ethical nature. Chief emphasis will be placed upon the problems of justice and equity. A study of the extent to which the existing distribution of the tax burden might be modified by lowering exemptions will be an important part of this section.

In the third chapter to follow, problems of a political nature will be considered. Chief among these is a study of the effect of a broadened income tax base upon tax consciousness and the possible effect of increased tax consciousness upon the nature of the demands made upon the government. The extent to which universal suffrage requires universal financial support of the government must also be considered.

In the fourth place, an analysis of administrative problems will be made. This is particularly important as administrative limitations will affect the extent to which it is practically possible to achieve the aims agreed to be desirable. For example, it may be concluded that ample revenues may be obtained from lowering the personal exemptions, but this will only be true if it is possible to prevent widespread evasion. It is also necessary to determine the percentage of revenue collected which must be expended in administrative costs. If a large part of the tax collected from those in the lower brackets is spent in increased administrative costs, the conclusion as to the social aspects of the tax will be

very different from that reached if the percentage were small. Though it is impossible to anticipate all the administrative problems which may arise, much can be done to suggest the general nature of the task to be accomplished.

## CHAPTER 2

### REVENUE ASPECTS

The potential yield of the lower bracket income tax is the basis for the greater part of the interest shown in this measure. Many states are in an unfavorable financial position and the federal government continues to depend on borrowed funds to finance a large part of its current expenditures. It is natural therefore, that there is interest in the proposal as a means of increasing the public revenue.<sup>1</sup>

An estimate of the amount of revenue obtainable at the suggested levels of exemption and rates will be made to determine the adequacy of the proposed remedy for the current financial ills. No attempt will be made, however, to estimate the effect of lower exemptions on the yield of the existing state personal income taxes, as in most cases there are inadequate sources of information. It is believed, however, that of the two, the federal estimates are of the greater importance. The probabilities are that if the federal government should lower the exemptions materially there would be slight chance of the states successfully doing likewise. Should the states go into this field if it is left free by the federal government, anything less than a complete series of estimates for each of the states would be inadequate, as the type of economic activity carried on in each state, the distribution of income, and the type of administration would be important in the determination of the amounts that might be realized.<sup>2</sup>

<sup>1</sup> The need for additional revenue if the federal budget is to be balanced in the near future seems clear. The federal deficit amounted to 1,384 million of dollars in the fiscal year 1938. It is estimated that the deficit for the fiscal year 1939 will be approximately \$4 billions and in the fiscal year 1940 \$3,320 millions. It is also probable that expenditures will have to be reduced before balance is achieved. See statement of Roswell Magill, former Under-Secretary of the Treasury, *New York Times*, November 17, 1938. Budget data and estimates are to be found in *The Budget of the United States Government for the Fiscal Year Ending June 30, 1940*, Washington, D. C., 1939, p. vii.

<sup>2</sup> See pages 124, 125.

Although there is currently an emphasis on the use of the lower bracket income tax as a source of additional funds it is also necessary to consider the possibility of this proposal as a means of improving the distribution of the tax burden. An estimate of the possible yield of the measure will provide a basis for the discussion, but it should be realized that the size of the exemptions and the rates will be determined in large measure by the decision as to the usefulness of the proposal as a means of reform.

Another point of importance is the relative stability of the income tax in the lower brackets. Although this is of secondary importance in the long run and there is considerable dispute as to its short run significance, the recent depression experience with the personal income tax has made the issue a live one. It is believed by many that the greater stability of the British personal income tax is based on the fact that British exemptions are lower than those prevailing in the United States, and it is urged that the United States adopt similar measures to avoid the necessity of either drastically modifying the rates or borrowing in the event of a depression. The extent to which lower exemptions might increase stability will be the object of the discussion. However, no judgment as to the desirability of increasing stability of revenue is to be implied.

### Amount of Revenue

The yield of a tax on a part of the income now exempt under the federal law will vary, of course, as the rate applicable is high or low and with the extent to which the exemptions are lowered. Another variable influencing the amount that might be obtained is the size and distribution of the national income. It must be remembered, therefore, that any estimate of the potential yield of the income tax on small incomes is dependent upon a series of assumptions so flexible that the estimate has little meaning without the complete statement of the assumptions made. When attention is turned to the actual problem of estimating the possible yield of the tax, new difficulties arise. In the first place, the data available on the distribution of incomes below the existing exemptions are very meager. The *Statistics of Income*,



the source of most estimates, does not afford complete statistics below the \$5,000 level, and because it is the distribution of potential tax returns by net income that is desired, available estimates of the distribution of the national income raise many difficulties which prevent their reconciliation with existing data and their use for the purpose in mind.<sup>3</sup> As a result, in the only estimates available recourse was had to the statistics from the state income tax departments of Delaware and Kansas.<sup>4</sup> Because of the small sample used and the many non-predictable elements which may arise if the effort is made to enforce an income tax with low exemptions on a national scale rather than in a single state, the estimates must be accepted as being, at best, but a rough measure of what the yield might be.

In Tables I and II below are presented estimates of the changes in revenue which might be expected to result from changes in the exemptions.

TABLE I. ESTIMATED YIELD OF PERSONAL INCOME TAX WITH VARIOUS LEVELS OF EXEMPTIONS \*

	1928 Incomes		1933 Incomes		1934 Incomes	
Exemptions:						
Married . . . . .	\$2,500	\$1,000	\$2,500	\$1,000	\$2,500	\$1,000
Single . . . . .	1,000	500	1,000	500	1,000	500
Dependent . . . . .	400	200	400	200	400	200
	(Yield in millions of dollars)					
Normal tax at 4 per cent <sup>a</sup> . . . . .	432	826	105	282	121	334
Surtax: 1936 Act . . . . .	2,474	2,574	379	407	413	454
Total tax . . . . .	2,907	3,401	483	689	533	788
Gain in normal tax . . . . .	394		177		213	
Gain in surtax . . . . .	100		28		41	
Total gain . . . . .	494		205		254	

\* Source *Facing the Tax Problem, op cit*, Table 7, pp 74-75

<sup>a</sup> Dividends assumed exempt from normal tax With this exception the net income subject to normal tax and surtax is as defined by the Revenue Act of 1936

<sup>3</sup> See statement by Susan S. Burr and William Vickrey in *Studies in Current Tax Problems*, 1937, "Estimating Income and Estate Tax Yields," pp 141-238, 173-178.

<sup>4</sup> *Ibid*, p. 177.

TABLE II. ESTIMATED NORMAL TAX YIELD OF INDIVIDUAL NET INCOMES UNDER \$5,000 AT 4 PER CENT FOR VARIOUS PERSONAL EXEMPTIONS, BY INCOME CLASSES OF \$1,000 \*

INCOME YEAR 1933	Personal Exemptions			
	\$ 2,500	\$ 2,000	\$ 1,500	\$ 1,000
Married.....	1,000	800	600	500
Single.....	400	400	300	200
Dependent.....	10%	10%	10%	10%
Earned income <sup>a</sup> .....				
Net Income Classes:	(Yield in thousands of dollars)			
\$ 0-1,000.....	87	87	317	9,038
1,000-2,000.....	5,718	5,718	15,742	71,152
2,000-3,000.....	5,699	8,133	22,428	54,888
3,000-4,000.....	6,652	11,454	20,231	30,688
4,000-5,000.....	6,709	9,253	12,929	16,726
Total.....	24,865	34,645	71,647	182,492
Additional tax on unearned income at 4 per cent. .	1,016	1,016	1,016	1,016
Total. ....	25,881	35,661	72,663	183,508
INCOME YEAR 1928				
Net Income Classes:				
\$ 0-1,000.....	189	189	414	8,972
1,000-2,000.....	18,244	18,244	39,259	153,321
2,000-3,000.....	20,109	25,273	57,147	128,240
3,000-4,000.....	17,322	27,393	46,325	68,996
4,000-5,000.....	22,704	30,439	41,635	53,212
Total ... ..	78,568	101,538	184,780	412,741
Additional tax on unearned income at 4 per cent .	2,464	2,464	2,464	2,464
Total ... ..	81,032	104,002	187,244	415,205

\* Source: *Studies in Current Tax Problems*, op. cit., Table E-11, pp 222-223. The 4 per cent normal rate is that of the 1936 Act. This table is not comparable to Table I because of the \$5,000 limit.

<sup>a</sup> The practice of allowing a deduction of an allowance for "earned income" has the effect of increasing the size of the personal exemption. For example, if a single man has an income of \$1,111.11 he will be relieved of any federal tax, the earned income credit making up the difference between the normal exemption of \$1,000 and total income of \$1,111.11.

With a normal tax rate of 4 per cent, the increase in revenue which might be expected to result from a lowering of the exemption from \$2,500 to \$1,000 for married persons, from \$1,000 to \$500 for single persons, and from \$400 to \$200 for each dependent, with a 10 per cent credit for earned income deductible in each case in the computation of normal tax, would vary from \$494 millions in a year with peak income, as in 1928, to \$205 millions in 1933, a depression year with incomes at an extremely low level. Though the difference between the high and the low figure is large, the sums involved in either case are of sufficient magnitude to make possible considerable changes in the federal tax structure.<sup>5</sup> In 1928 the federal tobacco taxes amounting to \$396.5 millions, or 12 per cent of the total tax revenue, could have been entirely replaced by the increased income tax yield resulting from lowered exemptions and the rate scale assumed above, with a balance left more than large enough to replace the automotive taxes, admissions tax, and capital stock transfer tax.<sup>6</sup> In 1933 the additional income tax revenue of \$205 millions would have been sufficient to offset approximately half the federal tobacco taxes for that year (\$402.7 millions) which were 22 per cent of the total tax revenue.<sup>7</sup> Perhaps even more important at this time when even normal federal expenditures have increased and the prospect for even greater expenditures appears to be more certain than for less expenditures, is the fact that this is one way in which a part of the increase may be met.

To those unfamiliar with the income tax the figures presented above may convey a false impression as to the actual contribution of the taxpayer now entirely free from federal income tax. This misunderstanding may result from the fact

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<sup>5</sup> Senator LaFollette roughly estimated that a reduction in the personal exemptions to \$2,000 for the head of a family and \$800 for single persons would bring the government \$110,000,000 in new revenue of which \$9,000,000 would be contributed by new taxpayers. (*New York Times*, October 17, 1937.) A more recent estimate of the increase in yield to be expected with the same reduction in exemptions has been made by Roswell Magill in his capacity as Under-Secretary of the Treasury. His figure is \$70,700,000. (*New York Times*, March 23, 1938.)

<sup>6</sup> See *Facing the Tax Problem*, *op. cit.*, Tables E and F, pp. 522-524.

<sup>7</sup> *Ibid.*

that under the law now in force personal exemptions are granted to all taxpayers regardless of the size of their incomes. The lowering of exemptions therefore not only brings within the income tax net many new taxpayers but also increases the tax payable by persons who would have paid some tax in any event. For example, a married couple without any children who receive a \$3,000 net income will pay a 4 per cent tax on \$200.<sup>8</sup> If their exemption is lowered to \$1,000 and their net income remains the same, they will have to pay a 4 per cent tax on \$1,700,<sup>9</sup> and will find the tax required with the new exemption over eight times as great as before. Though the additional tax is less important in the higher brackets where either a large or small exemption is only a very small part of the total income on which the tax is paid, the total additional tax collected from these taxpayers is large because the increased taxable income which results from lower exemptions is taxable at the highest surtax rate.

It is difficult to estimate just what part of the increased yield would come from taxpayers who had never paid an income tax before. Reference to Tables I and II indicates that the greater part of the increased revenue will come from persons with incomes of \$5,000 or less.<sup>10</sup> Assuming that all of the increase in revenue below the \$3,000 level comes from new taxpayers and that none of the increase above this level is from them, it may be concluded that with 1933 incomes a reduction of personal exemptions from \$2,500, \$1,000, and \$400 to \$1,000, \$500 and \$200 respectively will result in a collection of \$124 millions from new taxpayers or approximately 60 per cent of the total gain noted in Table I. In the same manner it may be estimated that with 1928 incomes new taxpayers will contribute \$252

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<sup>8</sup> The taxable income is \$200, not \$500, because there is an allowance of earned income credit of 10 per cent of net income. All income up to \$3,000 is considered earned under the 1936 Act

<sup>9</sup> If the 10 per cent earned income credit is retained

<sup>10</sup> For the income year 1928 the reduction of exemptions to \$1,000, \$500, and \$200 would increase the yield by \$494 millions. Of this, \$334 millions would come from increased collections on net incomes of \$5,000 or less. For the income year 1933 the total increase with a comparable reduction in exemptions would be \$205 millions, of which \$158 millions would be paid on net incomes of \$5,000 or less.

millions, a little more than 50 per cent of the total noted in Table I.<sup>11</sup> These two estimates, though even more uncertain than the others, are in many ways of much greater importance. The greater part of the increased yield which comes from those who have been income taxpayers previously could be obtained if there were to be an increase in the rates rather than a lowering of exemptions.<sup>12</sup> One difference in the two methods should be noted, however, with lower exemptions the major part of the increased tax yield would come from persons with incomes of \$5,000 or less and the result would be to make the income tax less progressive than before.<sup>13</sup> With no change in the rate scale, the change in distribution of the tax burden might be overlooked. However, if the same increase in revenue were obtained by increasing the rates applicable to existing income taxpayers so they would pay as much as under the alternative of lower exemptions, it would emphasize the fact that the change was

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<sup>11</sup> These estimates are rather rough as it is obvious that there are persons with net incomes above \$3,000 who are exempt from income tax under the 1934 Act who would not be with the lower exemptions, and also persons with net incomes of less than \$3,000 who would pay a tax under the 1934 Act and simply pay more under the proposed exemption level. However, the overestimate in the one case tends to offset the underestimate in the other and the essential point that a large part of the increased revenue from the lower exemptions would come from the larger tax paid by present income taxpayers remains valid. As it is also true that the income year selected and the level of exemption will affect the percentage from new taxpayers, a more refined estimate does not seem necessary. This difficulty has been avoided in several of the states by the expression of the exemption in terms of a tax credit rather than a dollar deduction from net income. Thus in Wisconsin, the first state to use this form of exemption, the personal exemptions are tax credits of \$8.00 for a single person, \$17.50 for the head of a family and \$4.00 additional for each dependent. If exemptions are changed the old tax base remains the same and there is no great difficulty in determining the amount of additional revenue that will be collected from the old income taxpayers. This type of exemption also has the effect of making the value of the deduction equal for all classes of taxpayers.

<sup>12</sup> This would be true except that the taxpayers with net incomes just above the exemption who may pay only a few dollars could not be expected to pay a tax at a rate sufficiently high to bring the same return.

<sup>13</sup> For example, a reduction in the allowance for a married taxpayer from \$2,500 to \$2,000 would increase his net taxable income by \$500. If net income were \$3,000 the result would be to increase the tax base from \$500 to \$1,000, in this case doubling the tax payable. If net income were \$5,000 the result would be to increase the tax base from \$2,500 to \$3,000 in this case increasing the total tax payable from \$100 to \$120. In the first case the effective tax rate would be increased from .6 per cent to 1.3 per cent, in the second from 2 per cent to 2.4 per cent.

affecting the progressivity of the tax and might prove more unpopular than the alternative which accomplished the same end. Theoretically this is of little importance, as it would be possible by lowering exemptions to gain the additional revenue from new taxpayers without increasing the liability of the old if the proper rate reductions were made. As a practical matter, however, the effect of exemptions on the tax paid or effective rate of taxation has received too little attention.

The estimates above are all made by the application of certain arbitrary rates and exemption levels to estimates of the distribution of the national taxable income. These rates and exemption levels are not to be justified except as they appear to be in harmony with the existing tax system and possible of enactment at some future date. The ethical justification for these rates and levels of exemption will be considered in the next chapter.

As there has been in the past a tendency to believe that the taxation of the very wealthy will provide unlimited revenues, there now seems to be a tendency to overestimate the revenue potentialities of the income tax on small incomes. The reduction in exemptions assumed is probably more severe than would be politically expedient, yet the additional revenue obtainable can be but a small part of the total tax yield. The main point to be made is not, however, that from a fiscal point of view the lowering of exemptions is not worth while, as it is obvious that any measure which may yield from \$200 millions to nearly \$500 millions must be attractive to treasury officials. It is rather to suggest that the gains are not of such great consequence as many may believe. With a deficit of over \$3 billions for the fiscal year 1935, over \$4 billions for 1936, over \$3 billions for 1937, \$1,384 millions for 1938, and approximately \$4 billions for 1939, it is obvious that unless expenditures had been greatly reduced the balancing of the budget would have required much more heroic measures than that of broadening the income tax base.<sup>14</sup>

There are two main reasons why the yield of the personal income tax in the low brackets is no greater than the estimates

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<sup>14</sup> Deficit figures, *The Budget of the United States Government for the Fiscal Year Ending June 30, 1940*, Washington, D. C., 1939, p. vii.

indicate. First, there is assumed in the estimates a relatively low rate of taxation on the new incomes. Thus, although there would be a tremendous increase in the number of personal income taxpayers, each one would pay at the lowest rate now applied to personal incomes. The second reason is that, although the number of potential income taxpayers may be multiplied several times by the reduction in the size of the exemptions to \$1,000, \$500, and \$200, the net income subject to tax would not be increased proportionately. This is due to the effect of the exemptions and the distribution of the national income. With the provision of any exemption comparable to the present type, the result is to make the tax rate effective on only that part of the income which is in excess of the exemption. Thus, if a married couple have an exemption of \$1,400 and an income of \$2,000, the tax at the rate of 4 per cent is paid on only \$600, the increase in the tax base being very much smaller than the amount of the new income included.

The effect of the distribution of the national income on the tax base is made clear by reference to two studies, that of the Brookings Institution and the recent study issued by the National Resources Committee. Although the two studies apply to different years and are based on different data and methods, they both clearly bring out the fact that the aggregate income of the lowest half of the population is very much smaller than that of the upper half.<sup>15</sup> Thus when the exemptions are lowered and large numbers of individuals are subject to the income tax, the combination of their small income, the deduction of the exemptions, and the low rate will result in relatively low collections as compared with that obtainable from the higher brackets

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<sup>15</sup> The Brookings Institution estimates that in 1929, 64.8 per cent of all personal incomes were \$1,500 or less and that the aggregate of all these incomes was only 28.8 per cent of the total national income for that year. On the other hand, it is estimated that for the same year 1.8 per cent of all personal incomes were \$8,000 or more and that the aggregate of these incomes was 27.9 per cent of the total (Leven, Moulton, and Warburton, *America's Capacity to Consume*, Washington, D. C., 1934, p. 207.)

The estimates of the National Resources Committee for 1935-36 indicate that "the highest five per cent of all families and single individuals—those with incomes of \$3,400 and over—received 27 per cent of the aggregate—almost as much as the lowest 60 per cent." (*Consumer Incomes in the United States*, National Resources Committee, Washington, D. C., 1938, p. 6.)

with the larger aggregate incomes and where the progressive rates begin to become effective. The concentration of income in the higher brackets and the use of highly progressive rates make it inevitable that the greater part of the yield of the personal income tax will come from the few rather than the many as long as these conditions prevail.<sup>16</sup>

### Stability

The personal income tax has been variable in yield expressed both as a percentage of total revenue and in absolute terms. The sharp drop in the return from this tax in the early years of the depression was particularly noticeable and has resulted in the consideration of the possibility of the broadening of the tax base as a means of making the yield less variable.<sup>17</sup>

The estimates given above in Table I, stating the potential yield of the personal income tax with lower exemptions in both prosperity and depression, will also serve to indicate the effect of the lower exemption on the variability of the personal income tax. Under business conditions and with reported incomes such as those for 1928 and 1933, it is estimated that with the rates and exemptions of the Revenue Act of 1936 in effect there would have been a decline in the yield of the personal income tax of 83.4 per cent between these two years. Under the same con-

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<sup>16</sup> In 1936 it is estimated that the income tax returns over \$5,000 were 12.51 per cent of the total but provided 95.02 per cent of the personal income tax revenue in that year. (See *Statistics of Income for 1936*, Part I, U. S. Treasury Department, Bureau of Internal Revenue, Washington, D. C., 1938, pp. 5, 6.)

<sup>17</sup> In 1930 the personal income tax return represented 32 per cent of the total federal tax revenue while in 1933 it was only 19 per cent of the total. This drop would have been even greater had it not been for the fact that the Revenue Act of 1932 lowered exemptions from \$3,500, \$1,500, and \$400 to \$2,500, \$1,000, and \$400, raised the normal tax rate and the surtax rates, and limited the extent to which capital losses could be used to offset other income. Although the yield of the personal income tax increased after 1933, as a percentage of total federal revenue it was even less in 1934, 1935, and 1936 than it was in 1933. This, however, is to be explained by the fact that here were added at this time several new taxes, the liquor tax and the gasoline tax in particular.

For a table showing the yield of the personal income tax as a percentage of the total federal revenue, see *Facing the Tax Problem*, op. cit., pp. 516-518. A convenient summary of the provisions of the various income tax acts is found in the *Statistics of Income for 1936*, Part I, U. S. Treasury Department, Bureau of Internal Revenue, Washington, D. C., 1938, pp. 138-148.



ditions and with the same tax rates assumed, it is estimated that with the personal exemptions at the level of \$1,000, \$500, and \$200 the decline between the two years would have been 79.7 per cent. Other conditions remaining the same, the effect of the lower exemptions is to decrease the variability of the personal income tax by 3.7 per cent. This figure indicates that there is no great advantage to be gained by the use of the lower exemptions as long as the other features of the present law remain the same. As the gross decline in the yield of the personal income tax is greater under the low exemptions than under the high, there is even the possibility that the general variability of the tax system would be increased should the lower bracket tax be substituted for some more stable source of revenue.

Advocates of the broader base for the purposes of increasing the stability of the personal income tax have often cited the relative stability of the British income tax, stating that the lower exemptions were an important reason for this feature of the British law. Although comparisons of the British and American laws are made difficult because of the differences in the definition of taxable income, they are sufficiently comparable to make this argument, if true, an impressive one. There is no question of the relative stability of the British tax. It is not at all clear, however, that the lower exemptions have had an important influence on the variability of the yield.

In the first place, there is the stabilizing influence of the British exclusion of capital gains and losses from the tax base. Most important, however, is the fact that the national income in Great Britain has not been nearly as variable in recent years as has been the case in this country. Estimates recently made by Colin Clark<sup>18</sup> for the years 1924-1933 reveal that the decline in national income in Great Britain from the peak for the period of £4,384 millions in 1929 to the minimum of £3,844 millions in 1932 amounted to only 13 per cent of the maximum, and that in 1933 there was an upturn in the national income figure. In contrast to this variation in the national income, the estimates for the United States indicate a fall from \$78,632 millions

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<sup>18</sup> Clark, Colin, *National Income and Outlay*, London, 1937, p. 88.

in 1929 to \$48,362 millions in 1932, and a further drop to \$44,940 millions in 1933, or a drop from peak to trough of 43 per cent.<sup>19</sup> In view of this great variation in the extent to which the tax base was affected by changes in business conditions, it should be clear that the use of the comparison between the British and United States laws with respect to stability is of little value.

In conclusion it is necessary to state again the limitations of the estimates presented. Not only are there problems of the interpretation of the limited data available and the necessity of making arbitrary assumptions as to rates and levels of exemption, but the estimates are subject to wide margins of error depending on the ability of the tax administration to cope with the problem of the collection of a personal tax from the lower income groups. The success of the administrative authorities will depend on the public response as well as the efficiency of the organization. It is also possible that even with a successful collection of the tax in the lower brackets there would be such high costs of collection that the net gain in revenue would be very much smaller than suggested by the figures given above. These questions will be considered in the chapters which follow.

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<sup>19</sup> *National Income in the United States, 1929-1935*, U. S. Department of Commerce, Washington, D. C., 1936, p. 22.

## CHAPTER '3

### THE THEORY OF THE PERSONAL EXEMPTION

In Chapter 2 the fiscal aspects of lower personal exemption were considered. It was concluded that, depending on the tax rate and the level of exemption, a considerable amount of revenue might be raised by a tax change of this kind. There was, however, no consideration of the factors which might determine the level of exemption or the tax rate. The extent to which the exemptions are lowered has, of course, a decided effect on the amount of revenue that may be collected. The higher the exemption, other things being equal, the less the revenue. The justification for an exemption of any particular amount is, therefore, important. Aside from political expediency and administrative practicability, the main grounds for exemption have been economic and social. It is this aspect of the problem with which this chapter will deal.

Much of the justification for income tax exemption has been based on the desire to achieve justice or equity in the tax system. Here, again, the difficulty of establishing any objective criteria must be recognized. The conception of justice will vary with time and place and is the result of the arbitrary decisions of whoever may be concerned with the problem.<sup>1</sup> It should, however, be one of the main objectives of any government. If a tax conforms to the prevailing standards, its chances of success are greater than if it is commonly objected to on the ground that it is unfair or capricious in its treatment of different individuals. It is also true that if there are frequent changes in the tax system, whether good or bad, the administration of the system will be increasingly difficult. It would seem, therefore, that a review of past and present practice and of past and present theory of exemptions is in order.

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<sup>1</sup> Colm, Gerhard, "The Ideal Tax System," *Social Research*, Vol I, No. 2, May 1934, pp. 319-342.

The modern income tax finds its roots in the income tax enacted in England in 1799. The English tax was in many respects different from the elaborate instrument now in vogue. It was at best a crude measure of net income and was administered with difficulty. The explanation of these differences is not hard to find. The tax was imposed to relieve the strain upon finances resulting from the Napoleonic Wars, and was emergency legislation without any precedent.<sup>2</sup> In general, the art of government was less fully developed than it is today. This may be attributed in part to the relatively simple political and economic structure. Not only was the political authority less concerned with refinement in techniques for achieving justice and equity, but the demands for refinements were less pressing. For these reasons the standards of justice and equity were, in general, not so rigorous as those prevailing at the present time. It is significant, however, that the Act of 1799 provided for the total exemption of incomes of less than £60 a year and an abatement from the normal rates for all persons having more than four children.<sup>3</sup>

This tax was abandoned in 1806 but was renewed in 1842. Upon renewal, the provisions for the exemption of a minimum were continued and have been a part of the income tax law ever since. The abatement for children was also continued as a part of the English law.

With this precedent for the exemption of small incomes, it is not surprising that when the first federal income tax was adopted in the United States in 1861 as a Civil War revenue measure, the tax was levied only on incomes in excess of \$800.<sup>4</sup> The second attempt of the federal government to tax incomes, in

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<sup>2</sup> Though fifteenth-century Florence and eighteenth-century France had taxes with many of the essential features of the personal income tax, they were far removed from the English tax of 1799. Seligman, Edwin R. A., *The Income Tax*, New York, 1911 (The Macmillan Company), pp. 46-53, 57, 72-80.

<sup>3</sup> *First Report from the Select Committee on Income and Property Tax*, Great Britain, House of Commons, 1852. Evidence of Charles Pressly, Commissioner of Inland Revenue, p. 2.

<sup>4</sup> The tax was modified several times before it was abolished in 1872. The exemption was at one time as low as \$600. See Seligman, Edwin R. A., *op. cit.*, pp. 430-468.

1894, provided for a \$4,000 deduction from net income.<sup>5</sup> However, before the tax was collected it was declared unconstitutional by the Supreme Court.

Finally, the ratification of the Sixteenth Amendment in 1913 led to the Revenue Act of 1913 which levied a general income tax which has been in effect, with numerous modifications, from that date to this.

The Revenue Act of 1913 provided for an exemption of \$4,000 for a married person and \$3,000 for a single person. However, neither this Act nor the Civil War Act provided for any abatement or allowance for dependents or children. It was not until 1917 when the rates were increased and the exemptions for married and single persons reduced to \$2,000 and \$1,000, respectively, that a \$200 credit for each dependent was introduced. Though there is no ready explanation for this failure to make allowance for dependents, it was probably, in the 1913 Act at least, a matter of indifference as the other exemptions were so large and the rates were so low that there was little pressure upon the legislature to make any allowances for differing family responsibilities.

In Germany the early development of the income tax provides an interesting variation of the rule set in England. Adopted by several of the German states from 1848 on, this income tax was not particularly successful until the Prussian income tax of 1891 was enacted.<sup>6</sup> Prior to this date there had been in Prussia a succession of acts modifying the Poll Tax of 1811, which gradually brought the tax closer and closer to the modern conception of an income tax.<sup>7</sup> However, as early as 1873 a minimum taxable income was prescribed, all persons with incomes below this level being exempt from the class tax then in vogue.<sup>8</sup> Thus it may be seen that even though the Prussian income tax grew out of a universal poll tax, it was found expedient to provide some sort of exemption.

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<sup>5</sup> Foster, Robert, and Abbot, Everett V., *A Treatise on the Federal Income Tax Under the Act of 1894*, Boston, 1894, p. 138.

<sup>6</sup> See Seligman, Edwin R. A., *op. cit.*, pp. 250-258.

<sup>7</sup> See Hill, J. H., "The Prussian Income Tax," in *Selected Readings in Public Finance*, by C. J. Bullock, New York, 1924, pp. 282-283.

<sup>8</sup> *Ibid.*

In the other countries now including the income tax as a regular part of their fiscal systems, exemptions of some minimum income from taxation are the rule.<sup>9</sup> Though the amount of exemption varies, the principle is well established and may be expected to remain so for some time to come.

In the 34 state income tax laws now in effect in the United States, the exemption of a minimum income is also a fixed policy. However, as in the different foreign countries, the amount of the exemption allowed varies considerably. For married couples, the highest exemption is \$3,000 in Alabama, and the lowest only \$1,100, in South Dakota.<sup>10</sup> It should be noted, however, that the majority of the state laws have been enacted within the past few years and that there has been in recent years a tendency for the states with unusually high or low exemptions to modify their laws to bring them closer to the average.<sup>11</sup>

With uniform principle of minimum exemptions carried out in such a variety of ways, there have naturally been many different theories advanced and justifications made for the policy pursued. It is to this aspect of the problem that attention will now be turned.<sup>12</sup>

Apparently the earliest, and certainly the most widely held justification for the exemption of small incomes from income tax is that it is wrong morally and undesirable economically to tax persons who are recipients of incomes only large enough or less than large enough to support life at a mere subsistence level. Though neither Smith nor Ricardo considered the specific question of exemption from income tax, there may be found in their respective theories of wages and wage taxation the basis for the theory of the exemption of subsistence incomes adopted by the writers of later years. Both these writers, believing that wages were regulated in general by the cost of subsistence

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<sup>9</sup> *Tax Systems of the World* (7th edition), The Tax Research Foundation (Commerce Clearing House, Inc., Chicago, Ill.), 1938, *passim*.

<sup>10</sup> The South Dakota exemption is expressed in the form of a tax credit of \$12. With the rates in force, the first \$1,100 of income are tax free.

<sup>11</sup> See Strayer, Paul J., "Possibilities of the State Personal Income Tax," *The Tax Magazine*, Vol. 16, No. 10, October 1938, p. 583.

<sup>12</sup> The practical problems of administration and of politics will be considered in Chapters 5 and 6.

or some habitual standard of living large enough to support the laboring population and to provide for its replacement, held that wages in general and in the long run could not bear a tax. Adam Smith believed that wages, if taxed, must be raised and that the burden would be shifted, in the form of higher prices, to the consuming public or, in the case of agricultural labor, to rent.<sup>13</sup> Ricardo, on the other hand, believed that the rise in wages attributable to any tax that encroached upon the subsistence of the worker would be taken out of profits.

It is the Ricardian viewpoint which is accepted by Mill<sup>14</sup> Mill, however, considered the actual problems of income tax exemption. Developing the theory of equal sacrifice, he held that,

To take a thousand a year from the possessor of ten thousand, would not deprive him of anything really conducive either to the support or to the comfort of existence; and if such *would* be the effect of taking five pounds from one whose income is fifty, the sacrifice required from the last is not only greater than, but entirely incommensurable with that imposed upon the first. The mode of adjusting these inequalities of pressure which seems to be the most equitable, is that recommended by Bentham, of leaving a certain minimum of income, sufficient to provide the necessities of life, untaxed. Suppose fifty pounds a year to be sufficient to provide the number of persons ordinarily supported from a single income, with the requisites of life and health, and with protection against habitual bodily suffering, but not with any indulgence. This then should be made the minimum, and incomes exceeding it should pay taxes not upon their whole amount, but upon the surplus. If the tax be ten per cent, an income of sixty pounds should be considered as a net income of ten pounds, and charged with one pound a year, while an income of 1000 pounds should be charged as one of 950 pounds. Each would then pay a fixed proportion, not of his whole means, but of his superfluities.<sup>15</sup>

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<sup>13</sup> *The Wealth of Nations*, Vol II, Book V, Ch. 2, Part II, Article III (Everyman's edition), pp. 346-347.

<sup>14</sup> Ricardo, David, *The Principles of Political Economy and Taxation* (Everyman's edition), Chap. XVI, p. 140. Mill, John Stuart, *Principles of Political Economy* (Ashley edition), Book V, Chap. III, Section 4, pp. 827-829.

<sup>15</sup> *Ibid.*, Book V, Ch. II, Section 3, p. 806.

The doctrine as expounded by Mill was very rigid and could not be said to support any theory of exemption to be used to equalize incomes. He was against progressive taxation of "superfluities" and stated that "The exemption in favor of the smaller income should not, I think, be stretched further than to the amount needful for life, health, and immunity from bodily pain."<sup>16</sup>

Mill not only established a case for the exemption of subsistence incomes from the income tax, he also realized that if there were other indirect taxes imposing heavy burdens on those with smaller incomes, the exemption under the income tax should be larger than the subsistence income, if income tax was not to add to the regressive nature of the total tax system. In his testimony before the Select Committee on the Income and Property Tax of 1852, he said, "It seems to me right to exempt from income tax, and from all taxes as far as you can, the amount required for the necessities of life. But under the present system of taxation, it is right to consider whether the remaining taxes do not press more on the smaller than on the larger incomes. I conceive that they do, and that this justifies the present exemption from the income tax of incomes under £150 a year."<sup>17</sup>

McCulloch, a contemporary of Mill, was in favor of granting an exemption of subsistence incomes but expressed concern over the possible abuse of the principle, fearing that the exemption might be used against the best interests of the upper classes.<sup>18</sup> He believed that "The income exempted from the tax, whatever it may be, should be held to be indispensable for subsistence, for otherwise there can be no good reason for its being exempted."<sup>19</sup>

A particularly vigorous stand in favor of the exemption of subsistence incomes was taken by J. B. Say. He contended

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<sup>16</sup> *Ibid.*, p. 807.

<sup>17</sup> *Second Report from the Select Committee on Income and Property Tax*, Great Britain, House of Commons, 1852. Evidence of John Stuart Mill, 17 May 1852, pp. 293-294.

<sup>18</sup> McCulloch, J. R., *A Treatise on the Principles and Practical Influence of Taxation and the Funding System*, London, MDCCCXLV, p. 139.

<sup>19</sup> *Ibid.*, p. 139.



that: "It would be somewhat bold to maintain that a parent is bound in justice to stint the food and clothing of his child to furnish his contingent to the ostentatious splendor of a court or the needless magnificence of public edifices." <sup>20</sup>

The more recent advocates of the subsistence theory have added little to the theory. Bastable believed that: "When exemption is claimed for the minimum it can only be on the ground that it will be employed in buying necessities; any other application of this amount fairly brings it under the weight of taxation." <sup>21</sup> Cassel, accepting Mill's theory of equal sacrifice as the basis for the distribution of the tax burden, would exempt the necessities from taxation. He does, however, in common with many other later writers, modify the strict interpretation of the concept of "necessaries." He contends that: "These necessities are not the necessities of merely physical subsistence; but are, to use the language of Professor Marshall, 'the necessities of efficiency.' Then as soon as taxation would interfere with the efficiency of any special class of the community, the sacrifice would be, in Mill's terms, quite incommensurable with that of the other classes, taxed only out of their surplus income above the margin of efficiency." <sup>22</sup>

Hobson agrees with Cassel and Marshall that exemptions at a level only large enough to provide for physical subsistence are not sufficient. Though he develops his own theory of tax distribution based upon the concept of "surplus income," the practical implications of his theory do not differ greatly from the more usual programs based upon either the equal or minimum sacrifice doctrines. He does, however, add a fresh note in his consideration of the reaction of organized labor to a tax on standard wages even though they may be above the subsistence level. He believes that: "A tax on low standards of wages would entail a loss of physical efficiency in the worker and his family, thus reducing the actual physical supply of labor power. A tax on the higher standards, reducing these elements of comfort or

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<sup>20</sup> Bullock, C. J., *Selected Readings in Public Finance* (3rd edition), New York, 1924, p. 159.

<sup>21</sup> Bastable, C. F., *Public Finance, op cit*, p. 320.

<sup>22</sup> Cassel, G., "Theory of Progressive Taxation," *Economic Journal*, December 1901, pp. 481-491.

pleasure which figure most clearly in his consciousness, would be met by a 'moral' revolt of organized labor that would have the same injurious reaction upon industry. Standard wages are therefore necessary elements of income with no true power to bear a tax." <sup>23</sup>

Pigou also develops an efficiency standard. He believes that conventional necessities are often given precedence over real necessities and that a tax upon incomes only large enough to include necessities, conventional or real, is likely to result in the retention of the conventional necessities and a cut in the real necessities. <sup>24</sup>

Dalton, one of the most liberal writers, associated with the Labor Party in England, believes that taxation upon the poorer members of a community should be avoided as it will reduce their efficiency and the future efficiency of their children. He says, "It is doubtful at what level of income the line should be drawn, below which taxation is likely to reduce efficiency.<sup>a</sup> But

"a It must, of course, be drawn considerably higher than 'subsistence level.' For the efficiency of those who have to live at or near this level is obviously less than it would be if their incomes were larger "

it is clear that, even in the richest modern communities, the incomes of a large section of the population still lie below it. Moreover, the line must be drawn at different levels for different classes of workers." <sup>25</sup>

Buehler, who has recently reviewed the various theories of exemption at some length, believes that: "Theories of exemption have often been based on the assumption that a given supply of population must be maintained,—probably due to the influence of the mercantilistic philosophy that a large population is necessarily a good thing in itself. . . . A more logical foundation for the theory of the exemption of a minimum of subsistence from taxation is the assumption that taxation should not be

<sup>23</sup> Hobson, J. A., *Taxation in the New State*, London, 1919, p. 16.

<sup>24</sup> Pigou, A. C., *The Economics of Welfare* (1st edition), London, 1920, p. 595.

<sup>25</sup> Dalton, Hugh, *Principles of Public Finance* (9th edition), London, 1936, pp. 104-105.

employed to modify conditions of population, but to raise revenue." <sup>26</sup> He believes, with Ricardo and Mill, that taxes upon subsistence tend to be shifted from the poorer elements of society to the richer classes through readjustments in the population supply and advances in wage rates, and that although it is possible to avoid a decline in population by the expenditure of government revenues upon those impoverished by taxation, it is more desirable to avoid creating paupers by taxation by exempting a minimum of subsistence <sup>27</sup>

A most attractive theory to justify the exemption of an income providing simply the necessities is the theory that it is necessary to provide some allowance for the reconstitution of the capital value of man. Though it has been considered in the past, <sup>28</sup> it fits most neatly into the concept of taxable income now in vogue in the United States. As the concept is developed in the United States, taxable income is the net income remaining after the expenses necessary to the acquisition of income are deducted from gross receipts. It may be argued, therefore, that if the expenses of running a machine are a fair deduction from its product, the essential living expenses of man are also necessary to the acquisition of income and should be deductible. The comparison may be carried even further and the special expense necessary to raise children capitalized and then deducted year by year as is the allowance in business for depreciation and obsolescence of capital goods.

Though it is possible to present many more variations of the ideas expressed above, it does not seem worth while. They are, for the most part, variations on the same theme and are all inadequate explanations of the actual policies of the tax authorities the world over. The discrepancy between theory and practice is emphasized by the fact that the various countries of the world continue to obtain a large portion of their revenues from tariffs, excises, and similar measures, the burden of which is generally believed to fall in large measure upon the same persons

<sup>26</sup> Buehler, Alfred G., "Taxation and the Minimum of Subsistence," *The American Economic Review*, Vol. XXIII, No. 2, June 1933, pp. 234-244.

<sup>27</sup> *Ibid.*, p. 235.

<sup>28</sup> de Marco, Antonio de Viti, *First Principles of Public Finance*, London,

who have had a minimum of subsistence exempt from income tax.

There are only two explanations of the actual policy followed that seem to fit the facts. The first is that it has been found expedient for political and administrative reasons to exempt a large part of the population from an income tax. It is the practical politicians' desire to "pluck the goose with the least squawking." Many believe that this may be done by what are known as hidden taxes rather than by a direct personal income tax. The belief is that if a tax is paid in small doses, as in the sales tax, or is a part of the final sales price to the consumer, it will cause much less notice than if the same amount were to be payable in fairly large sums throughout the year. The administrator tends to believe that the best tax is the simplest and the least costly to collect. It has been indicated in the previous chapter that the number of taxpayers increases rapidly with even slightly lowered exemptions and that the revenue per taxpayer is not likely to be very great. This would inevitably result in higher costs of collection and, it may be feared by some, in complete disruption of the administrative machinery. Both the administrative and political problems will receive analysis below. It is easy to see, however, why there is the tendency on the part of politicians and administrators to shy away from lower exemptions.

The second justification for the exemption of small incomes from the personal income tax that seems to fit the facts might well be associated with the first. It is that, once it is recognized that it is either desirable or inevitable that the smaller incomes are going to be taxed heavily by indirect means, these same persons are certainly not in a position to pay an additional income tax. If it is desirable to prevent regressive taxation or to encourage progressive taxation, this may be done at the present time only if the smaller incomes are exempt from the personal income tax. This position is supported by the evidence which will be presented below which will indicate that below the level of income tax exemption the existing tax system is regressive. Thus, if a thoroughly progressive tax system were to be achieved, it would be necessary to lessen the existing taxation of

the poorer members of the community. This explanation does not imply, of course, that the use of indirect taxes is wise.

In 1920 the Report of the British Royal Commission on the Income Tax contained the following revealing statement:

The truth is that the exemption limit has never in this country been based on a figure consciously related to any kind of minimum subsistence, and that if our financial condition had warranted it the exemption limit in 1914 might quite possibly have stood at £200 or £300 instead of £160.<sup>29</sup>

Here, it seems, variation in the exemption level has been used as a means of adding to or subtracting from the yield of the income tax. This is possible as the level of exemption not only determines the number of taxpayers but also has the effect of changing the taxable income of the income taxpayers in the top brackets. A decrease in the exemption from £300 to £160 would add £140 to the net taxable income under the British law. As the rates are applied to taxable income, not gross, this will increase the amount of income subject to the highest rates.

This state of affairs is not true of England alone. Jensen, reviewing the history of the exemptions under the federal income tax, neatly disposes of the subsistence doctrine as a basis for actual policy. He says,

The most fetching argument is found for the exemption of an amount required for a minimum standard of living. . . . But these exemptions are tempered by the need for revenue and other considerations. The federal income tax of 1913 exempted \$3,000 to a single person, and \$4,000 to others, and these levels were maintained in the 1916 act. In 1917, due to the pressure for revenue, the exemptions became \$1,000 and \$2,000 respectively, and so remained during the 1918 act, despite the rising cost of living which ought, on the theory of a minimum cost of living, to have required increased exemptions. In 1921 and 1924, despite lower living costs, the exemptions were again raised and became \$1,500 and \$3,500 respectively, in 1926.<sup>30</sup>

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<sup>29</sup> *Report of the Royal Commission on the Income Tax, 1920*, London (His Majesty's Stationary Office), p. 55.

<sup>30</sup> Jensen, J. P., *Government Finance*, New York, 1937, pp. 305-306

Shoup agrees with Jensen and believes that the minimum of subsistence argument has little practical effect, "inasmuch as the same governments that grant this exemption tax even the poverty stricken classes through various indirect taxes, particularly excises, customs duties, and a certain part of the property tax." <sup>31</sup>

Though Jensen and Shoup are critical of the exemption of subsistence as an explanation for the income tax deductions now granted, they do not take a stand against the practice. They do not believe it is an adequate explanation of the facts of the case. On the other hand, Cohn, Taussig, and Lutz believe that there is no justification for the exemption of subsistence incomes.

Cohn believed "The sympathetic attitude of this theory of taxation towards the people involves an unsympathetic attitude towards the state." <sup>32</sup> Taussig wrote that, "Considered as a matter of principle, it is by no means desirable that workingmen as a mass should not be subjected to taxes. . . . There is no ground for the assumption that the mass of workingmen in advanced countries have barely the 'living wage' and should therefore be exempted. It is fit that they too should contribute toward the public charges." <sup>33</sup> Lutz's position is the most emphatic of the present-day writers on the subject. He contends that "The structure of existing income taxes at this point has been influenced by the contention of early nineteenth-century writers that a certain 'minimum of subsistence' should be tax free. There has never been any agreement as to the proper amount of such a subsistence minimum, nor any consideration of the economic, as distinguished from the political logic and consequences of such a policy. The argument is not valid, in any case, as an objection to a theory of universal personal taxation." <sup>34</sup>

The arguments of Cohn, Taussig, and Lutz are alike in that they are based upon a political theory which holds that there

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<sup>31</sup> Shoup, Carl, "Tax Exemption," *Encyclopedia of the Social Sciences*, New York, 1934, Vol. XIV, pp. 528-530.

<sup>32</sup> Cohn, Gustav, *The Science of Finance*, Chicago, 1895, p. 328.

<sup>33</sup> Taussig, F. W., *Principles of Economics* (2nd edition), New York, 1918, Vol. II, p. 522.

<sup>34</sup> Lutz, H. L., *Public Finance* (3rd edition), New York, 1936, p. 474.

should be no privileges of citizenship without conscious payment to support the government granting these favors, and also in that they are concerned about the abuses which might result from the extension of the principle until a minority was contributing all funds used for the benefit of the majority.

The difficulty of defining what should be included in a minimum standard of living and the measurement of this minimum is also stressed by those who oppose the exemptions. It is argued that the minimum is different at different times, that it varies from place to place, and that workers in different occupations do not require the same allowance. It is concluded, therefore, that the granting of allowances is impracticable. Few persons would disagree with the statement that a refined measure of what constitutes a subsistence income is, for administrative reasons, impracticable. However, there is little force in the conclusion that because of the difficulties of measurement the deduction should not be granted. If there is a need to make allowances for subsistence incomes, it seems logical to hold that an exemption which is imperfect is still better than none at all.

A much stronger argument against the exemption of a minimum of subsistence is that advanced by Marshall, Stamp, and others, that if state expenditures are more productive than private expenditures, the gain to the workingman from government expenditure may be greater than the sacrifice entailed in the taxation of subsistence.<sup>35</sup> It is of interest to note, however, that although Dalton stresses the idea that the expenditure of revenue is just as much a part of the study of taxation as the sacrifices, he would not deny the exemption to the small income receiver.<sup>36</sup> Dalton's belief in the exemption of small incomes regardless of the benefits of governmental expenditures is based upon his acceptance of the policy of governmental intervention in the distribution of the national income. He believes that taxation should be used to promote the maximum social advantage and that, at the present time, this may most nearly be realized by the exemption of small incomes and liberal expenditures for the benefit of the underprivileged. Granted a different

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<sup>35</sup> See Buehler, Alfred G., *op. cit.*, p. 236.

<sup>36</sup> Dalton, Hugh, *op. cit.*, pp. 8, 47.

distribution of the national income, with wage earners receiving a larger share, his conclusions as to exemption and expenditure policy might be different.

Although this approach is useful in consideration of matters of general policy, it is subject to severe limitations when it is applied to some specific problem. What is wanted is some measure of the benefits conferred by governments upon persons in different income classes. It may be possible to measure costs in cases where there are direct outlays for such purposes as relief or perhaps even for housing. The difficulty arises when the expenditure is one made for the community as a whole and the benefits accruing to each individual are uncertain. However, even if it were possible to measure the cost of the service or good enjoyed by the individual, would it be fair to say that he had benefited to that extent? The troublesome problem of the person who receives a service he does not want, or wants less than some other, is bound to arise. Should the cost of this improvement which he did not want be considered as an offset to some other tax burden imposed upon this man? He would certainly protest such a conclusion.

This qualification of the practicability of considering tax burden and expenditure benefit together is not meant so much as criticism of the idea, which is believed to be a real improvement on the old idea of considering the tax alone, as it is to again emphasize the fact that, in the end, the conclusions arrived at with respect to tax distribution are a matter of opinion as much as anything else.

This question of government intervention in the distribution of national income is probably more important than any other single factor in the determination of policy. Believers in any theory of tax distribution, such as equal or minimum sacrifice, will differ on the distribution of the tax burden if they do not agree with each other on the justice of the existing distribution of the national income. Thus, if the expenditure of government revenues is included in the discussion of the problem, there is no reason why the acceptance of the equal sacrifice theory, the minimum sacrifice theory, or any other theory of tax distribution should logically lead either to a policy of exemption of



small incomes or to their taxation. The important variables in arriving at a decision as to policy are the distribution of the tax burden, the distribution of the benefits of government services, and the pain inflicted by the first and the satisfaction received from the second. As a calculus to measure these quantities has yet to be devised, their measurement on an objective basis is impossible. The final decision arrived at will depend upon the individual who is debating the matter. If he believes that the general welfare can best be promoted by a lessening of the present inequality of incomes, he will favor high exemptions and large expenditures for the benefit of the masses. If, on the other hand, it is believed that there is substantial justice in the distribution of income at the present time, a program of high exemptions and large expenditures will not be favored.

In some cases concern is indicated regarding the obvious responsibility of all citizens to contribute to the state and an effort is made to restrict the expenditures of government to the bare essentials. An example is found in the believers in the benevolence of the "unseen hand" who fear the social and political consequences of a policy which would consciously alter the distribution of income by taxation, and hold up as an ideal a tax system which is completely neutral in its effects. However desirable this may seem, it is most difficult to achieve in a modern democracy. The tariff is an example of a tax which may profoundly alter the distribution of income. On the expenditure side, such items as expenditures for public education and public health are firmly established. Almost every act of government has some effect on the eventual distribution of the national income. It is idle to object to exemptions from income tax on these grounds. The real issue is what sort of redistribution is desired and to what extent should it be carried.

McCulloch claimed that once the government adopted a policy of interference with the natural order of events, we would be "at sea without rudder or compass."<sup>37</sup> Seligman argued against Wagner's socio-political theory of taxation in a similar fashion but justified many of the ideas of Wagner in a different way.<sup>38</sup>

<sup>37</sup> Bullock, Charles J., *op. cit.*, p. 241.

<sup>38</sup> *Ibid.*, pp. 258-268.

Certainly McCulloch would not favor progressive income taxation as advocated by Seligman, yet both agree upon the abstract theory of neutral taxation. Though Seligman claims to favor progressive income taxation because of its conformity to his "faculty" theory of taxation, it might be more nearly correct to say that Seligman is not adverse to the taxation of those who have for the benefit of the "have-nots," as long as it does not result in rapid or violent change in the status quo. This is the real issue from the practical point of view.

The inadequacy of anything but a frank admission of one's aims and preconceptions is made clear by the fact that even the most elaborate theories of tax distribution based on the premise of the diminishing marginal utility of money incomes provide no positive basis for determination of the type of tax distribution that should follow. One of these theories, the theory of equal sacrifice as worked out by Mill, assumes that justice is to be had by making the sacrifice of taxpayers as nearly equal as possible. As Pigou, in criticizing Sidgwick, so clearly points out,

On the basis of Sidgwick's intuition to say nothing of the claims of equi-proportional sacrifice, there is at least as good a case for taxation which makes net satisfactions equal as for taxation which makes sacrifices equal. Indeed, there is a better case. For people's economic well-being depends on the whole system of law, including the laws of property, contract and bequest, and not merely on the law about taxes. To hold that the law about taxes ought to affect different people's satisfactions equally, while allowing that the rest of the legal system may properly affect them very unequally, seems not a little arbitrary.<sup>89</sup>

Other expressions of a similar nature are found in the writings of Bastable and, more recently, in the work of Simons and Kendrick. Bastable believed that:

The distribution of taxation may be said with far more justice than the distribution of wealth in general to be "a matter of human institution solely." Like all questions into which the conception of "ought" or rightness enters, it is an ethical one; but its correct

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<sup>89</sup> Pigou, A. C., *Public Finance*, London, 1928, p. 60.

solution is so bound up with economic and financial considerations, that it must remain within the field of financial inquiry.<sup>40</sup>

Simons summarizes his position in the following statement:

At any rate, it may be best to start by denying any justification for prevailing inequality in terms of personal desert. This position has the great virtue of being definite; and it seems more nearly defensible than any other simple position relevant to the immediate problem. If one refuses to accept this dogma, one's error cannot be demonstrated by resort to scientific or dialectical analysis. We may plead, remonstrate, preach, and exhort; but we cannot prove. But one dogmatic assertion is permissible, namely, that by no other means can the problem be dragged out into the open. Taxation must affect the distribution of income, whether we will it or not; and it is only sensible to face the question as to what kind of effects are desirable. To do this is to reduce the discussion frankly to the level of ethics or aesthetics. Such a procedure, however, is certainly preferable to the traditional one of "describing" the attributes of the good life in terms which simply are not descriptive.<sup>41</sup>

Kendrick's analysis of the basis of the ability-to-pay theory of taxation challenges the validity of the basic assumptions of declining marginal utility of money, the sacrifice involved in the payment of taxes and the quantitative expression of that sacrifice. He reaches the following conclusion:

But whatever support may be indicated and related to the rate structure, it is important that graduated taxation shall be founded on the broad realities of the economic system, and not on the thin nebula of hedonism in reverse. Then decisions as to the use of such taxes can be governed by economic considerations. Taxes are imposed by collective action. They have economic effects; and these effects, in turn, entail consequences for the society levying the taxes. The choice of the taxes to be laid, and the rates at which they are to be applied expresses, therefore, a preference for one set of economic effects and hence of social consequences to another. Such are the facts. The theory should correspond.<sup>42</sup>

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<sup>40</sup> Bastable, C. F., *op. cit.*, p. 281.

<sup>41</sup> Simons, Henry C., *Personal Income Taxation*, Chicago, 1938, p. 18.

<sup>42</sup> M. Slade Kendrick, "The Ability-to-Pay Theory of Taxation," *The American Economic Review*, Vol. XXIX, No. 1, Part I, March 1939, pp. 92-101.

In practice other factors are also important. There is, first of all, a limit to which a government can afford to expand its program of social services and give up its revenue from those taxes which are collected indirectly from all people, rich or poor. Equally important is the political problem of representation without taxation.

A review of the attitudes of the various writers considering the exemption of a minimum from income tax reveals the importance of individual value judgments in the formation of each writer's conclusions. Although objective formation of conclusions is impossible, there has been a tendency for the use of various theories of exemption of a minimum as an explanation of the existing levels in an unrealistic manner. The most common error has been that of failing to include within the scope of the individual discussion the total tax system. Exemption of a minimum from income tax is of particular significance in its effects on the distribution of the tax burden. Its true significance will be realized, however, only if the effect of other existing taxes is considered. To avoid this difficulty and in order to bring the discussion of the exemption of a minimum up to date, the following chapter will be devoted to the consideration of the immediate problems confronting the person wishing to form his own conclusions on these matters.

## CHAPTER 4

### THE EXEMPTION LEVEL AND THE DISTRIBUTION OF THE TAX BURDEN

Consideration of the practicability of lower personal exemptions requires that attention be turned to the effects of such a change on the existing distribution of the tax burden. In the previous chapter it was concluded that the point of view or general attitude of the individual concerned was the determining factor in the position he took with respect to this problem. As the conclusions formed in this study are dependent on the convictions of the author the first part of this chapter will be devoted to the development of his concept of the ideal distribution of the tax burden. In the latter part of the chapter attention will be turned to the evaluation of the present tax system on the basis of the ideal standards selected and the consideration of the possibility of achieving the ideal distribution.

#### The Ideal Distribution of the Tax Burden

**The Desirability of a Progressive Tax System.**—The few general principles that are believed to provide the essential basis for the proper distribution of the tax burden are rather exacting in their demands in spite of the fact that they may be stated in general terms. In the first place, it is believed that a good, just, equitable, or socially desirable tax system should be progressive throughout the entire tax structure. This requires that, beginning with the poorest person subject to any taxation at all, other things being equal, it is necessary to have the tax paid, directly or indirectly, increase as a per cent of individual income as incomes increase.

Upon this point there is considerable agreement among the more modern authorities. Not only do the academic writers

agree,<sup>1</sup> but the idea has penetrated popular thought and has been the basis for actual legislation in all parts of the world. All the large democratic nations in the world pay at least lip service to the idea of progression by the imposition of at least a progressive income tax.<sup>2</sup>

There are many reasons for this point of view. One is that to obtain the revenues necessary to run the modern government and still maintain a democracy, it is necessary to adopt the principle of progression. Evidence of this fact is found in the timing of the adoption of this principle in this country and the attaining of truly progressive rates in England. In both cases the rates were low throughout the income tax structure, giving at best the mildest sort of progression, until the extraordinary expenses began to mount. The most important of these are the outlays necessary to conduct a war. As a matter of fact, the progressive income tax was thought of as a war revenue measure and a temporary tax in its early use in England.<sup>3</sup> In our own country the first attempt to use the progressive income tax by the federal government, prior to its final adoption in 1913, was during the period of the Civil War. However, the Act of 1894, which never became effective, was an exception to the rule as it was coupled with the lowering of the tariff, the main source of federal revenue. Extensive use of the other chief type of progressive tax, the death duty, is of even more recent origin

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<sup>1</sup> Dalton, Hugh, *Principles of Public Finance*, *op. cit.*, p. 94. Lutz, H. L., *Public Finance*, *op. cit.*, pp. 361-363. Seligman, Edwin R. A., *Progressive Taxation in Theory and Practice* (Publications of the American Economics Assn.), Third Series, Vol. IX, 1908, *passim*.

<sup>2</sup> *Tax Systems of the World* (7th edition), Tax Research Foundation, Chicago, 1938, *passim*.

<sup>3</sup> "Dealing first with the history of the Income Tax, I have pointed out that the Income Tax in this country had its origin in the financial necessities occasioned by the expense of the great war at the end of the 18th Century. . . . But, as a matter of fact, the Crimean War intervened to render it impossible to repeal the Income Tax then, and, indeed, in 1885 it stood at a higher figure than it afterwards reached till quite recent times . . . and in more recent times it has become recognized that a tax which originally was conceived as a war impost, and a temporary tax, must be, at any rate, one of the main taxes, if not absolutely the paramount tax in British taxation." (Evidence of Mr. R. V. N. Hopkins, C. B., a Commissioner of Inland Revenue, Royal Commission on The Income Tax, *Minutes of Evidence*, Cmd. 288-1, London, 1919, No. 45, p. 4.)

and may be correlated with the continued rise in the expenditures of the government.<sup>4</sup>

Another reason for this turn to the progressive type of tax is found in the nature of the distribution of incomes. With 27.9 per cent of the total national income being received by 1.8 per cent of the population, it is easy to point out the advantages of the progressive tax as a means of adding needed revenues.<sup>5</sup>

The change in the attitude of people toward the social obligations of the state is also believed to be a factor leading to the adoption of the progressive tax. This has developed in recent years in more than one way, and it is only natural that it should have had its effect upon measures of taxation. Examples of the results of this change are found in the flood of what is generally included under the head of social legislation. Although England has been in advance of this country in such measures as unemployment insurance and old-age pensions, our attitude is not greatly different and, at the present time, we seem to be trying to make up for lost time. The idea that there is an American standard of living which should be maintained even though it require a considerable redistribution of wealth from the wealthy to the poor is one that has gained considerable favor in recent years. It may follow, then, that a good part of the basis for the theory of taxation according to ability is to be found in the desire to express in some relatively innocuous form the idea that the wealthy have an obligation to see to it that the less fortunate have at least the essentials of decent living. Emphasis upon what is necessary to have "equality of opportunity" has made it clear that many of the persons with an income in the lower brackets have less than is necessary even before any tax is imposed.

The policy of enlightened conservatism practiced in England and often referred to as "Tory Socialism" may also have had its

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<sup>4</sup> Lutz writes: "Death taxes are not a modern invention. Such levies were used by the Romans, or even by earlier nations, and there was some discussion of the subject, together with some fragmentary applications of the tax, during the Middle Ages. Their development on an extended scale and in a sufficiently systematic manner to produce significant revenue is a matter, however, of the last generation." (Lutz, H. L., *op. cit.*, p. 659.)

<sup>5</sup> See Chapter 2, page 17.

influence in this country. There is a story told of one of the most prominent of the early American advocates of the income tax amendment carrying great weight with his more wealthy friends by arguing that the income tax was a small price to pay to avoid the worse extreme of socialism.

Still another reason for the trend toward the progressive tax is the fact that as the nature and extent of the activities of the government grew more complex and increased in total amount it was recognized that the older theories of tax distribution, such as benefit or cost of service, were inadequate. An example is the impossibility of justifying the assessing of citizens for public education on the basis of the benefit received. The need therefore arose for a theory of tax distribution more nearly in accord with the practice of the time. In this case it seems only natural that thought was turned to the basic liberal ideal of public action to promote the greatest good for the greatest number. At first this was interpreted as requiring proportionate taxation, but as time went on and the changes noted above took place this was gradually turned into a basis for the support of a progressive tax.<sup>6</sup>

Granted that this idea of progressive taxation is basic at the present time, it does not necessarily follow that it is completely carried out in practice. It is of particular importance to the problem of lower bracket income taxation to see if the tax system is progressive in the lower brackets and then to suggest what the result of lower exemptions might be on the progressivity of the tax system in the lower brackets. This will be the subject of inquiry in the second part of this chapter.

**The Principle of Equality.**—The second broad principle of tax distribution that will afford a basis for the critical examination of the proposal to lower the exemptions of the income tax is the principle of equality. That is, it is believed that the tax system should tax persons with similar capacity equally. It is believed that this requires that allowance should be made for the fact that persons with equal incomes do not always have the same responsibilities and thus the same capacity to pay for the

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<sup>6</sup> Simons, Henry C., *Personal Income Taxation*, Chicago, 1938, pp. 3-5.



cost of government. It would seem to follow, therefore, that the ideal tax would be one that assessed each individual separately, recognizing the fact that each person may have a different capacity to bear taxation. Taxes whether originally imposed on some business or some piece of property must always affect the individual. The tax system that goes furthest in recognizing this principle is the one that comes closest to meeting the ideal of equality of treatment.<sup>7</sup>

This principle of equality is to be considered effective, however, only in the case where the general revenue is being considered. That is, when it is considered desirable to impose taxes for some purpose other than the general needs of the treasury, it no longer holds true in the same manner. Examples of this sort of tax are important, as it is the practice of many governments to use the tax system for the purpose of control or of corrective justice. Thus, the tax on liquor, if it is accepted as desirable for the purpose of reducing consumption, may fairly result in different tax burdens for individuals with the same income and responsibilities if one is a drinker and the other is not. The same would hold for the taxation of unusual profits in time of war if it is believed that the use of the tax system is necessary to correct the windfall gains of producers of war materials.

The idea of equality in its simplest form goes back at least as far as the basic principles of Adam Smith and is found in the writings of most of the men since his time.<sup>8</sup> The discussion of the problem of double taxation is based in large measure

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<sup>7</sup> Cohn believes, for example, that "Among the great shortcomings of the taxes on consumption (to confine ourselves to this category) is to be counted the circumstance—which viewed from another side is a merit—that the collection of the tax takes place without reference to or contact with, the person on whom it is intended that the burden should rest. We proceed on nothing more definite than the estimated average of the proportion between the consumption of the taxable article and the taxpaying capacity of the individual." (Cohn, Gustav, *The Science of Finance*, translated by T. B. Veblen, Chicago, 1895, p. 614.)

<sup>8</sup> The first of Smith's four canons was that of equality. Seligman writes, "The great problem which still remains, however, is to elucidate the exact nature of this economic justice. Everyone agrees that the essential ingredients of this scheme are equality, or uniformity, and universality of taxation." (Seligman, Edwin R. A., *Essays in Taxation*, 10th edition, New York, 1928, p. 317.)

on the acceptance of the idea that it is unfair to tax two individuals of equal capacity in different amounts just because they happen to obtain their incomes from different sources.

The growth of the idea of making allowance for the fact that persons of equal income may have different responsibilities is, however, more recent. Until the adoption of the income tax, little was or could be accomplished. The development of the idea may be explained in the same manner as the growth of the idea of progression. It is probably an outgrowth of the rising sense of social responsibility and concern for the individual member of the state.

Another explanation is that only as the administrative machinery of the taxing authorities was perfected could a proposal such as this even be considered. First, it is necessary to have an income tax and then a smoothly working one. Other types of general tax are not able to meet the demands of equality. A sales tax, customs duty, or property tax is levied upon a sale or the value of property, and although it may be recognized that it is the individual who eventually pays the tax, there is no opportunity to make allowance for the individual status of each of the persons upon whom the final burden rests.<sup>9</sup> This may be attempted very roughly by careful selection of the commodities to be taxed. It is, however, impossible to hope for much by measures of this sort.<sup>10</sup> On the other hand, the income

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<sup>9</sup> Stamp writes, "If we survey the history of taxation over the world in general, we can see that as nations become stronger in their administrative power, and as their ideas of taxation develop, so they employ the more subtle and delicate instruments of direct taxation, the effects of which are better understood and more under control, and as their ideas develop they get away from their primitive economic notions of 'taxing things.' People are only now waking up, looking over the world in general, to the fact that though taxes may be put upon things and apparently paid by things, they are actually paid by persons, and are ultimately referable as burdens on a person's total resources." (Stamp, Sir Josiah, *Studies in Current Problems in Finance and Government*, London, 1924, pp. 207-208.)

<sup>10</sup> In the recent Twentieth Century Fund study, the following conclusion is reached: "A system of commodity taxes made up of a number of these selective taxes, each carefully chosen because of the particular group that it burdens, might seem to offer considerable possibility of adjustment to the personal status of taxpayers. However, the number of such highly selective taxes that are administratively feasible is small, and the experience of the federal government during and shortly after the war, and again during the recovery years after 1932, has shown that the revenue from these sources is almost negligible." (*Facing the Tax Problem*, *op. cit.*, p. 319.)

tax affords the opportunity to carry this idea to any extreme that is considered administratively practicable. At the present time there are few persons who would deny the justice of the additional personal exemption granted to married persons and for dependents, although they might object to the size of the specific allowance made by the present law. Another type of allowance that has been received with favor in England and the United States is differentiation between "earned" and "unearned" incomes. In its simplest form this type of discrimination is justified by the argument that the unearned income, generally thought of as investment income, is more regular than the earned, and the additional security afforded the individual with a regular income is proper justification for the imposition of a heavier tax.

Recognition of the fact that individual responsibilities, as well as income, are important in the determination of taxable capacity is a logical development in the attempt to attain the goal of the greatest good for the greatest number. It is a policy that is closely followed, however, in a democracy only. If the state becomes more important than the individual, and the prestige of the nation or the race the goal toward which all efforts are directed, concern over the minor problems and refinements of individual equity are likely to vanish.

As with the principle of progression, this principle of equality will be used to test the existing tax structure and will provide a critical basis for the evaluation of the proposal to lower the exemptions. If it can be proved that with lower exemptions it will be possible to come closer to the ideal as expressed by this principle, then another point in favor of the direct taxation of small incomes will be made.

**Basic Exemptions.**—Other points that have to do strictly with the distributive side of the question are not of great importance if it is recognized that the administrative and the political problems will receive separate treatment below. One problem, however, falls on the border line and should receive some mention at this point. It is the problem of the universality of taxation. Is there, as Cohn believes, an obligation of all citi-

zens of a democratic state to pay something to the government? <sup>11</sup> He believes that the maintenance of an orderly society by government makes it possible for persons to live in something other than a state of chaos and thus implies that there is a universal obligation. Although this is primarily a problem that falls into the political aspects of this discussion, it is necessary to reach a conclusion on the moral or ethical and economic issues involved.

With the exclusion of taxes justified on the basis of definite benefits or services rendered, the argument in favor of a strict interpretation of the principle of universality, for other than purely political reasons, is that the government is just as essential to the poor as the food that they eat to support life and that there is no justification in the belief that they have a moral right to be relieved from their share of the general governmental expenses unless it is also believed that they should be relieved from the necessity of paying the competitive price for the other essentials of life. This is basically the same argument referred to above as the basis for Taussig's refusal to admit the propriety of exemptions of the minimum of subsistence.<sup>12</sup> It is weakened, however, by the fact that the society in which we live is not willing to carry out the theory of distribution of economic goods on the strictly competitive basis to its logical conclusion of permitting the unemployable or temporarily unemployed to starve and the very poor to go without at least some assistance in the form of various health projects and other types of subsidies.

Thus one finds that although the citizen may pay taxes to enjoy his rights as a citizen, the state will turn and with the other hand give him assistance that in effect is an offset to the tax burden. For example, if the total tax burden for a year is \$5.00, and benefits in the form of free dental work worth, on the average, \$10 00, are provided by the state, is there any point in collecting the \$5 00 in the first place? It may be decided that the cost of collecting the tax represents a waste, unless the political reasons for its imposition are strong enough to outweigh

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<sup>11</sup> See the discussion on this point above (page 32)

<sup>12</sup> *Ibid.*

this fact. The argument continues along the following line: If there were no tax, the government could reduce the subsidy for dental work by \$5.00 plus the cost of collecting the tax and charge the recipients of the service the difference, the net gain to the community being the fact that there was no effort wasted on the collection of the tax in the first place.

There are two flaws in this type of reasoning. First, there is no assurance that the individual will spend the \$5.00 for dental work believed to be socially desirable. In the second place, with the practice of universal taxation and then redistribution it is possible to spread costs, if the individual need for them is irregular, in such a way\*that they are not prohibitive to those who need them at some specific time. Using the example suggested above, it may be that the incidence of dental expenses is such that, if there were not the \$5 00 tax on all persons who were entitled to the free service, the cost to the particular individuals who needed the service would be not \$10 minus the cost of tax collection but \$20.<sup>13</sup> This might be so high that those who needed the service could not afford it, even though in the long run the costs might be identical. In its simplest form the argument boils down to the statement that it is desirable for the government to compel the citizen to contribute to a sort of cost-spreading scheme, this in his own interest and in that of the community as a whole. This argument becomes even more effective in cases where the control of some communicable disease is concerned. Another way of putting the case for the universal tax is that in many cases it is found that the government is a better and more efficient distributor of income than the individual acting alone. Although this may be objected to by some as a socialistic policy, it is being done at the present time and probably will become more important in the years to come.

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<sup>13</sup> A study by the Committee on Costs of Medical Care found that "while 69 per cent of families with incomes of \$1,200 to \$2,000 had charges of less than \$60 (for medical service), these families incurred only 24 per cent of the total charges for all families in this group. At the other extreme, the one per cent of families with charges of \$500 or over incurred 13 per cent of the total charges for the group. A similar unevenness is found among families in all other income groups." (*Medical Care for the American People*, Final Report of the Committee on Costs of Medical Care, Chicago, 1932, p. 18.)

In this case the variations in the individual need for the service provided would not be a controlling factor.

The belief in complete exemption of persons with the smallest incomes is maintained by those who favor a policy of direct intervention by the state. They hold that, insofar as it is possible without greatly reducing production, it is desirable to give generous subsidies to the less able and fortunate persons in the lower income classes. If the same revenue is to be obtained the rates on the upper bracket incomes must be raised. This position has the virtue of being a direct statement of a position and course of action. It is, however, more disturbing politically than the alternative of taxation, and then provision of benefits to make up for the fact that the tax would reduce the standard of living of people who were below a decency standard at the beginning. The inclusion of even a small tax seems to satisfy many persons because of their failure to realize that government expenses are for the benefit of the same people who pay the tax.<sup>14</sup>

The position that will be taken in this study is that the goal to be worked toward is one where there will be no tax on the person with an income below a mere subsistence level. With the great dependence now placed on the various levies weighing heavily on the poor, there is much progress to be looked forward to before the question of specific levels and rates is raised in anything but academic discussions. The extent to which it will be necessary to tax the group between the subsistence level and that which has a clear surplus will depend upon many factors. The most important are the total needs of government, the total national income, and the nature of the original distribution of that income.

The writer believes that the only position tenable at the present time is the recognition of the fact that there is a problem of poverty in this country and that, insofar as possible, it is

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<sup>14</sup> Dalton refers to another reason for this attitude. "An ingenious formula, of Cambridge origin, is that the rich should pay more taxation than they think, while the poor should think they pay more than they do. 'This double illusion, it is argued, will keep the rich contented and the poor virtuous, and will tend to maximize work and saving by all classes.'" (Dalton, *op. cit.*, p. 49.)

the government's responsibility to use its tax system to reduce the bad effects of this condition as much as possible. In a dynamic situation the policy followed must be flexible but should have a specific goal toward which to work. The general goal is the maximum social good. Specifically, the writer believes that this may be attained by a greater degree of equality than prevails under the present system of production and distribution. The gain in happiness that would result from even a moderate amount of additional social services for the poor is believed to be great. The real difficulty arises from the fact that it may not be possible to provide these services on the basis that the social conscience would approve and still maintain political stability and economic productivity. Within this limitation the practice must be evolved.

### The Achievements of the Present Tax System

**Is It Progressive?**—Uniform and consistent progression was held to be an objective worth striving for. It is therefore of interest to see, insofar as is possible, whether or not the present tax system is truly progressive and if not, why not. Interest is, of course, centered on the question of progression in the lower brackets. There seems, however, to be little doubt that the present tax structure is progressive in the income classes, at least from \$5,000 up.<sup>15</sup> It is in these ranges that the personal income tax, the estate tax, the gift tax, and various inheritance taxes are most effective. All these taxes are now assessed on

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<sup>15</sup> This statement is based upon the recent estimates made by Professor Mabel Newcomer. A slightly older study made by Miss Yaple, using a different technique, indicated that progression of direct taxes stopped at the \$500,000 income class. Although the taxation of the upper income classes is not of great importance in this study, it is suggested the difference in conclusions is magnified by the fact that Miss Yaple's analysis is based upon the rates in effect in 1924, and 1927-1933, whereas Professor Newcomer uses the rate schedules in effect in the calendar year 1936. As the full effect of the 1932 rise in income and estate tax rates had not been fully reflected in the Statistics of Income for 1933, used by Miss Yaple, her conclusions are not based on data even approximately comparable to those used by Professor Newcomer (See Yaple, Maxime, "The Burden of Direct Taxes as Paid by Income Classes," *The American Economic Review*, Vol. XXVI, No. 4, December 1936, pp. 691-710; Newcomer, Mabel, "Estimate of the Tax Burden on Different Income Classes," in *Studies in Current Tax Problems*, The Twentieth Century Fund, New York, 1937, pp. 1-52.)

a progressive rate scale, which in the case of the income tax and the estate tax is now the most severe in the history of federal taxation. There seems to be no question that the objective of a progressive tax is not only achieved but also desired. In the very low brackets, however, progressivity is not so certain.

In the lowest brackets there is much to be gained from a rather careful analysis of the present situation. First, it should be realized that only a very small part of the total population ever pays a tax that is assessed on a progressive principle. With income tax exemptions relieving a married man with \$2,778 from this tax, estate tax exemptions of \$40,000 plus an additional \$40,000 life insurance, and no other truly progressive taxes levied on a wide basis, the total number of persons subject to these levies is very small. A study by the Twentieth Century Fund of the total number of income taxpayers that might be expected with different levels of exemption indicates that unless the level of exemption is lowered there is little chance of the total number of income taxpayers becoming much greater than four or five millions.<sup>16</sup>

It must be concluded, therefore, that in the lower brackets the tax burden imposed at the present time is the result of the imposition of various taxes with proportional rates. Although it is possible to conceive of proportional taxes being selected in such a manner that the burden of the entire tax system would be progressive, the practical attainment of this end has not proved to be possible.<sup>17</sup>

It is possible to obtain a clear picture of the situation by considering some examples of the way in which the tax burden might be expected to fall on individuals in specific instances. Although it is common to see in the newspapers some such statement as "25 per cent of the dollar of the consumer goes for hidden taxes," these statements have usually had some political origin and may not be relied upon as a fair estimate of the true burden.

The only recent estimates that are inclusive and have any truly objective basis are those made by Professor Newcomer

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<sup>16</sup> *Facing the Tax Problem, op. cit.*, pp. 355-357.

<sup>17</sup> See page 44.



for the Twentieth Century Fund. These elaborate studies were made because the staff of the Fund believed that "most of the tax burden estimates have, of course, been partisan in nature, and need not be taken seriously."<sup>18</sup> One of the weaknesses of the partisan estimates is the fact that the assumptions of the nature of tax shifting were very simple and dogmatic. Usually the simple assumption that all indirect taxes are shifted to the consumer in full is made. This is not proved by those using it and is a matter on which the current economic theorists will not agree. To avoid this difficulty the estimates made by Professor Newcomer are based on five different sets of assumptions as to the nature of tax shifting.<sup>19</sup> To avoid the difficulty that there are no two state and local tax systems that are the same, the hypothetical taxpayers were considered, in one case, to be residents of New York, and in the other, of Illinois. New York and Illinois were chosen because they are examples of states that have very different types of tax systems. New York has developed the income tax to a great extent, obtaining approximately 24 per cent of state funds and 5 per cent of total state and local revenues from this source. The only state that obtains a greater percentage of its revenue from the income tax is Massachusetts.<sup>20</sup> On the other hand, Illinois is a state that has no income tax and has relied to a large extent on the sales tax and the property tax. Illinois includes personalty in the property tax base. New York has no general sales tax and does not include personalty in the property tax base. In both states the property tax is not used by the state but is reserved for the use of the local governments. This is not, however, unusual at the present time.

The general assumptions with respect to the incidence of the various taxes imposed by the various states are summarized in the following statement:

In general, it has been assumed that income, death, and gift taxes are not shifted; that business taxes, other than those on net income

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<sup>18</sup> *Facing the Tax Problem*, *op. cit.*, pp. 548-549.

<sup>19</sup> See Newcomer's study, "Estimates of the Tax Burden on Different Income Classes," in *Studies in Current Tax Problems*, *op. cit.*, pp. 1-52.

<sup>20</sup> Strayer, Paul J., *op. cit.*

and capital stock, may be shifted to the consumer in part or entirely; and that land taxes may be capitalized in part or entirely. For income, death, and gift taxes some variation has been assumed, not because of shifting, but because of changes in the ownership of property and income within the family. Only business net income, capital stock, mortgage, and stock transfer taxes remain unchanged with respect to both shifting and intrafamily distribution of ownership through the five series of assumptions.<sup>21</sup>

The conclusions of this study are presented in Table III below, indicating that the tax burden for the different sets of

TABLE III. TOTAL TAX BURDEN, FEDERAL, STATE, AND LOCAL, AS PERCENTAGE OF POTENTIAL INCOME \*

	Income in Dollars for Various Occupations <sup>a</sup>									
	Farmers			Wage Earners		Salaried Worker	Merchant	Salaried Worker	Corporation Officials	
	500	1,000	2,000	1,000	2,000	5,000	5,000	20,000	100,000	1,000,000
NEW YORK FAMILIES:										
Series <sup>b</sup>										
I	12.0	10.9	9.8	18.6	17.2	20.8	23.9	31.6	44.3	84.5
II	15.0	11.4	9.7	15.4	14.2	18.8	24.5	30.6	41.0	83.6
III	15.0	11.4	9.7	15.4	14.2	18.8	24.5	30.6	44.0	83.6
IV	19.1	15.3	13.2	17.6	16.4	20.9	27.8	31.9	45.7	84.5
V	12.0	10.9	9.8	18.6	17.2	20.8	25.6	37.4	60.3	100.1
ILLINOIS FAMILIES:										
Series <sup>b</sup>										
I	11.2	10.4	9.2	19.3	18.2	20.5	20.6	27.2	38.4	81.0
II	12.7	10.0	8.0	15.0	14.2	17.7	52.9	26.5	38.6	79.9
III	14.6	11.6	9.5	15.0	14.2	18.9	40.7	30.1	41.6	81.4
IV	15.6	12.4	10.1	16.9	15.9	19.3	54.0	27.7	39.9	80.8
V	11.2	10.4	9.2	19.3	18.2	20.5	22.4	32.8	55.7	101.6

\* Source. *Facing the Tax Problem*, op. cit., Table 26, p. 232.

<sup>a</sup> This income figure is income actually received. It is not the base used for computing the percentage of income paid in taxes. The base used for the percentage computations is "potential income"—that is, the income that would have been received if the taxes had not existed—since some of the taxes are in fact paid out of this potential income, not out of income actually received.

<sup>b</sup> These series designate the sets of assumptions on which the estimates are based. Variations in ownership of property and income within the family, as well as in shifting, have been included. (See *Facing the Tax Problem*, op. cit., pp. 226-227, for assumptions of each series.)

taxpayers in terms of per cent of their total potential <sup>22</sup> income. Of greatest importance to the question in hand is the fact that there appears to be a decided regressivity in the tax burden in the income classes below \$2,000. The conclusions of the authors of the study on this are interesting and are presented in full.

All the estimates indicate that the tax burden is regressive for those income classes not subject to income and death taxes. This regressivity is largely due to the assumptions that the ratio of expenditures to income is greater for small incomes than for large incomes and that the rate of assessment is higher for small properties than for large properties. For the higher income groups, whose tax burden is dominated by personal income, corporation income, and death taxes, the burden is definitely progressive.

For families of the same income, the wage earners have a heavier tax burden than the farmers, owing primarily to the higher property taxes in urban areas. If none of the tax on land is capitalized, however, the farmer has a somewhat heavier burden since he has a larger investment in land.<sup>23</sup>

In the more detailed analysis of the figures that is presented by Professor Newcomer in the basic study, there is the additional observation that the tax burden of two individuals with similar incomes and capacity may be quite different. The cause of this variation is given in this statement from that study:

Other assumptions, or various combinations of the foregoing assumptions, might reasonably be made, but those given are probably sufficient to demonstrate that, as the result of many variables, the tax burden may vary widely for individuals of the same income. The variations given above are the result of assumptions that may or may not be valid. But there is no reasonable doubt that, if the true tax burden were known for a considerable group of individuals, wide variations would still be found for individuals of the same income. Even if it were known that just half of the sales tax was shifted to the consumer and half were borne by the merchant, it would not follow that just half would be shifted in each instance. More probably it would be found that some merchants were in a position to shift the entire amount and others were in a position

<sup>22</sup> See note "a," Table III, page 52, for use of this term.

<sup>23</sup> *Facing the Tax Problem*, *op. cit.*, pp. 232-233.

to shift none at all. The extent to which the tax on land is capitalized would also vary, doubtless, with individual circumstances.<sup>24</sup>

The only reasonable deduction to be made on the basis of the material presented is that in the lower income classes there has been little effort to assure a truly progressive tax burden and that the taxes chosen have been the result of the inclusion of other considerations than a desire to achieve the most equitable tax system that would be possible today. It is encouraging to note, however, that there seems to be a real progression in the tax system from the \$2,000 income level up.

In the lowest brackets there is reason to believe that the taxes chosen were selected on the basis of administrative practicability and revenue-producing capacity.<sup>25</sup> It may also be true that there is a tendency to continue to use an old tax, such as the property tax or the various tobacco taxes, after they have been an established part of the tax system over a long period of years. In many cases, however, the final decision is the result of the power groups' relative strength. In bad times the need for revenue is so great that measures which would have little chance of passage in normal times will be accepted without much effective protest.

The experience of the federal tax policy in recent years is of interest in this regard. After the depression was well under way and the revenues had begun to fall off, the need for action was apparent. In 1932 there was enacted a new tax bill which raised the income tax rates to a point only slightly below that which prevailed during the war, increased the estate tax rates drastically, added a federal gift tax, and also imposed many

<sup>24</sup> Newcomer, Mabel, *Studies in Current Tax Problems*, *op cit*, p. 40.

<sup>25</sup> In the minority report of the Colwyn Committee on National Debt and Taxation, there is the following explanation of a comparable condition in Great Britain: "We have found very little support, but much condemnation, among witnesses for indirect taxation in principle. *We are ourselves of opinion that taxes upon commodities, regarded as part of a general system for raising money required for State expenditure, are objectionable in principle, and that the important place which they occupy in our tax system can only be defended on the ground that they are survivals from a period when the administration of direct taxation was much more difficult than it is today.*"

"Our objection to indirect taxation rests primarily on its necessarily regressive character."

"... Taxation should mitigate, not aggravate, inequality in the distribution of income." (*Report of the Committee on National Debt and Taxation*, Cmd. 2800, London, 1927, No. 70-72, p. 372.)

new excise taxes, notably a series of automotive taxes. With the repeal of prohibition in 1934 there was passed a series of liquor taxes, and in the same year there were increases in the estate and gift tax rates. In 1935 the estate and gift tax rates were again raised to a new high, and there were also increases in the personal income tax rates in the income brackets above \$50,000. In the 1936 Act, dividends were made taxable under the normal tax and the undistributed profits tax was passed.

Although there was considerable protest about the high income tax rates, the taxation of capital gains, and particularly the undistributed profits tax, the generally prosperous conditions in 1936 and early 1937 did not give the opponents of these measures a very good basis for an effective campaign against them. When business conditions suddenly turned in the latter part of 1937 there was a concerted cry from the ranks of the high taxpayers to the effect that the tax policy of the government was responsible for the new depression. With this level the new tax legislation in 1938 was directed to the relief of the particular group that was the most vocal at the time. The result is well known. The tax on capital gains was sharply reduced for persons in the high brackets and the undistributed profits tax was made much less severe.

Although there seems to be little hope in the years to come of a reduction in the aggregate tax bill, there will undoubtedly be continued dispute as to who is to pay the additional taxes.

In this discussion of the tax burden in the lower brackets there has been no mention of the newly imposed social security taxes. Although these taxes are included in the Newcomer study, there is some question as to whether the whole burden should be included in the particular study in question. This question is raised because of the fact that the benefits in the form of old-age annuity, at least, are directly connected with the amount contributed in taxation, and allowance is made for payments made in the event of death prior to the receipt of the annuity. This allowance is paid to the estate of the deceased. The point to be made is that payment of 1 per cent of a salary for the old-age annuity is in many respects very similar to a compulsory savings plan, and it is doubtful if it should be in-

cluded in the general tax burden.<sup>26</sup> As the old-age contribution will eventually become 3 per cent, if the present law remains in force, the inclusion or exclusion of this item will make considerable difference in the total burden in the low income groups subject to the tax. It should not, however, affect the progressivity or regressivity of the tax system in the lower brackets to any marked degree, as it is a proportionate tax and based on wages received rather than expenditures. The other social security taxes are the tax on the employer for the old-age annuity fund and the payroll tax on the employer of eight or more for unemployment compensation. It is impossible to determine the final incidence of these levies, but the presumption is that a part will be shifted to lower income classes in the form of higher prices or lower wages. In either case they will tend to add to the regressivity of the present distribution of the tax burden.

**Is There Equality in Taxation?**—The second major requirement of a good tax system is that persons with equal capacity to bear taxation should pay equal taxes. Little was said about what the measure of capacity was believed to be. It was suggested, however, that it is desirable to make allowance for such factors as differing responsibilities as well as variation in the size of the tax base. Before any further progress can be made it is necessary to examine the possibility of measuring capacity in more detail.

Fundamentally, as is the case with all concepts of value in economics, the tax burden is thought of as the loss of satisfaction or pleasure resulting from the payment of money, either

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<sup>26</sup> Dr. Burns makes a distinction between the old-age annuities and the old-age pensions. She states that "The annuity, being paid as a part of a contract between the contributing worker and the federal government, belongs absolutely to the annuitant, who can spend it just as he wishes or save it to bequeath to his heirs. The pension is a form of public welfare, paid as a concession and not as a right, and can be claimed back by the state out of any property the aged person may leave when he dies. The annuity plan is paid for by taxes on employers and workers. The old-age assistance pensions are paid out of general taxation levied by the federal and state governments." She states a little later, "Thus the plan (old-age annuity) is really a compulsory savings plan with insurance features for those who live long enough." (Burns, Eveline M., *Toward Social Security*, New York, 1936, pp. 14-15, 21.)

directly or in prices, to the government. Although this concept is vague and may be severely criticized by the sophisticated, it is still the best there is. Until some more practical measure is devised, it serves the useful purpose of giving the policy-maker some point at which he may start. The weakness of this concept lies in the fact that the human race is conceived to be motivated entirely by pleasure and pain, a theory no longer acceptable to the psychologist. The difficulties arise from the fact that there are no controls which permit the exact measurement of response to different stimulæ and there is no unit measuring pleasure or pain that may be used to arrive at a total of the satisfactions that a person may receive in a given year, and no unit accurately measuring the quantity of pain resulting from the imposition of a tax by a government.

However, as it is a money economy in which these problems arise, it is believed that if the analysis is raised to the money level there will be a satisfactory compromise. This assumes that the gain or loss of money or money's worth is a fair measure of the gain or loss of satisfaction. This is probably far from the case in many individual instances, but until a better measure is found it will have to serve.<sup>27</sup> Certainly the assumption that persons with equal money incomes may enjoy equal satisfactions is more reasonable than an assumption that, on the whole, they do not. Once it is granted that the money base is the only one that affords a basis for measurement, it is inevitable that equality may be achieved only by taxing persons with equal money incomes and equal responsibilities to the same extent.

The measure of responsibility is the same as the measure of

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<sup>27</sup> Dalton supports a similar assumption, to the effect "that the relation between income and economic welfare is the same for all taxpayers," with the following note:

"Some economists, chiefly in England, of the London individualist school, have emphasized that this is only an assumption—none who have used it have claimed that it was more—and have pronounced it both 'unscientific' and untenable. But this is an assumption which, in civilized countries at any rate, equity demands and politicians and administrators, at least, must make. Nor is it so remote from reality as some critics suggest. Most of us, at given levels of income, are more like each other in our normal needs and moods, and in our reactions to variations in our income, than some theorists recognize." (Dalton, *op. cit.*, p. 92.)

net satisfactions. However, the allowance for differing responsibilities is to be justified on other grounds than its effect upon satisfactions. The most important allowances are those for the differences in size of family. Perhaps the best explanation for granting special consideration to those with dependents is found in prevailing belief in the family as a desirable social institution.

Using the monetary measure, the task of determining whether or not the present tax system conforms to the demands of equality becomes relatively simple. Again the emphasis is to be placed on the lower income brackets, and the taxes that are imposed with special regard to particular benefits will be excluded from this discussion. For example, the gasoline tax is earmarked in many states to provide for the expenses of maintaining the highway system. The fact that the car owner pays a gasoline tax when the non-car owner with equal income and responsibility pays none, is justified on the theory that the car owner receives special benefits in the form of roads which are sufficient to require special treatment of this individual. Other taxes to be excluded are the liquor tax, imposed at least in part for the purpose of controlling consumption in the public interest, and the excess profits tax, which may be justified on the theory that the way in which the income was received or its source gives adequate basis for special treatment of this particular type of income.

In the local tax systems the property tax provides the major part of the revenue. Does it place a burden on the taxpayer in the lower income brackets that conforms to the standard of equality? There is, first of all, some dispute as to the extent to which the real estate tax is a benefit tax. It is justified by some on the theory that the services provided by the local government in the modern community are so essential to the ownership of property that these levies may be thought of, at least in part, as benefit taxes or prices rather than taxes for the support of general governmental functions.<sup>28</sup> The group that

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<sup>28</sup> For a statement of this case, see: Spengler, Edwin, "Is the Real Estate Tax a Benefit Tax," Memorandum Number Five, *Report of the New York State Commission for the Revision of the Tax Laws*, submitted Febru-



holds to this view would try to separate from the general property levy the benefit from or the cost of the provision of such services as sewerage, police protection, garbage collection, and the like, and leave only the revenue necessary for maintenance of such things as public education, health, etc., to be considered as expenses that should be met out of a general levy.

Granting the cogency of this point of view, there still remains a problem of the part of the property tax that cannot be allocated on this basis. As it is possible that the functions of local governments will not be reduced but may expand in the future, it is still important to determine the general nature of the distribution of the burden of the real estate tax, the major source of local funds.

It is generally believed that the property tax should be divided into two parts for the purpose of the discussion of the incidence of its burden. In the first place, the tax on the land is believed to be borne by the owner of the land, or capitalized by the buyer and the burden left on the hands of the owner at the time the last unpredictable increase in the rate was made.

The result is that insofar as the land owner is in the income class with which this study is concerned, he is believed to be subject to a tax in proportion to the value of his land holdings or to no tax at all, depending on the possibility of capitalization. No allowance is made under this tax for the fact that a poor man may hold more land than a rich one or for the fact that owners of the same type of land with equal incomes may have different responsibilities. It may be concluded, therefore, that even under the most ideal property tax, the tax on the land does not fulfill the requirement of progressivity or equality. Although there may be some tendency for persons in the same income class to hold similar amounts of land, this is only a generalization that may be made if the total population is considered. The difference in the amount and value of land held in different parts of the country is marked and the variation from urban to rural sections is also great.

When the imperfections of administration are taken into

account, the land tax is even further from the ideal of a tax assuring equality. Although some progress is being made in the improvement of the assessment technique, there is apparently a need for much more. Variation in the tax rate per thousand dollars of actual value of real estate has been estimated to range, in a single city, from \$36.69 to \$60.95 on different classes of property, this not accounting for the extreme range that might be found in a single class.<sup>29</sup>

One redeeming feature of the situation with respect to the incidence of the tax on land is the fact that it is generally believed that the present owners have had, in many cases, an opportunity to capitalize the tax and thus be relieved of a major part of the burden.<sup>30</sup> As capitalization may take place only on the sale of land, the result is that it is the past owners of land who are the most severely hurt by the inequality of this tax. It may be concluded, therefore, that the repeal or drastic reduction of the land tax and the substitution of the lower bracket income tax would not be a sure way to achieve a greater degree of equality.<sup>31</sup> It is, however, reasonable to conclude that if additional local revenues are needed, unless the land tax is greatly improved the use of some other measure would be desirable from the point of view of equity.

The other forms of property taxation are of considerably more importance than the tax on the land alone. This is true because, even without the assumption of the possibility of capitalization, the land tax is believed to be borne by the owners and the value of land owned by the poor is not as great as other forms of property. For example, although the farmer may own considerable land, the need for housing and a place to work is practically universal. Thus, the taxes on property of this sort

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<sup>29</sup> Martin, James W., "Municipal Revenues and Expenditures," *The Tax Magazine*, Vol. 16, No. 6, June 1938, p. 330; cf. Silverherz, Joseph D., *The Assessment of Real Property in the United States*, Albany, N. Y., 1936, p. 213.

<sup>30</sup> See "Report Submitted to the Commission by Robert Murray Haig," *Report of the New York State Commission for the Revision of the Tax Laws*, submitted February 15, 1932, Legislative Document (1932) No. 77, pp. 127-131.

<sup>31</sup> *Report of the New York State Commission . . .*, *op. cit.*, Minority report of Commissioners Seligman and Straus on relief to real estate p. 46.

are almost certain to have some effect on the person in the lower income classes.

As in the case above, there is considerable agreement as to the final incidence of the tax on improvements. In normal times the tax on other property than land used in business is borne by the final consumer of the product produced by this business, and the tax on improvements and personalty in the hands of the final consumer is borne by the owner. This means that tenants of even the poorest dwellings or tenements are paying to their landlord a tax in their weekly or monthly rent. The real question that the economist has to face is whether or not it is possible for the landlord to shift the whole tax burden to the tenant at all times. If, as is generally believed, the condition of the market is important in the determination of the extent to which it is possible to shift the tax to the tenant, then it becomes impossible to assign with any degree of accuracy the actual amount of the burden borne by the tenant. As there is not a single, universal market, the extent of the variation due to this factor is, of course, practically unlimited. Thus, it is possible that the percentage of the tax shifted in the Borough of Queens will differ from that in the Bronx, and that two taxpayers with equal capacity, measured by the standards set up above, will bear unequal burdens, even though the tax were assessed on a basis that conformed exactly to the proper values of the two pieces of land. In one case the tenant may bear the entire burden, and it is entirely possible that in the other the tenant will bear none at all.

The conclusion must be that the property tax on improvements is, at best, a poor way to assure equality in the distribution of the tax burden. If a better tax could be used to provide the same amount of revenue, there is no reason why it should not be used at least to relieve the taxpayer of the arbitrary burden assigned in this manner. As there is no problem of the capitalization of the tax in the past, there is nothing that should prevent action from being taken if a desirable substitute can be found.

The extent of the burden imposed by all property taxes has been measured by Professor Newcomer in the study of the

distribution of the tax burden referred to above. She concludes that the farmer in New York with an income of \$500 will pay a property tax of \$31.50 directly and will bear a burden amounting to \$11.85 indirectly, if it is assumed that the land tax is entirely capitalized and that taxes on improvements and business property are shifted entirely to the final consumer. For the farmer with an income of \$1,000 living in New York it is estimated that the same assumptions will result in a burden of \$45 and \$23.70 respectively. Other estimates are as follows: farmer with \$2,000, direct \$73.50, indirect \$52.65; wage earner with \$1,000, direct \$85.50, indirect \$30; wage earner with \$2,000, direct \$167.40, indirect \$60. <sup>6</sup>

The marked difference in the direct burden borne by the farmer and the wage earner is the most noticeable feature of these estimates. It is not, however, the most significant feature. The difference may be explained in large measure by the fact that the farmer lives in rural communities where the costs of government are low and the services provided small, while the wage earner lives in the cities and towns where costs and services are great. As it is still believed that there should be local government and decisions made by the localities as to the extent of the services that are considered necessary, this difference does not prove inequality. The main significance of these estimates is that, even in the lowest income brackets, the burden imposed by this type of tax is large and the chance for really significant discrimination is great.

The remaining taxes that impose a burden on the lower bracket income may be considered together. They are the various excises imposed by the federal government, the federal customs duties, the sales taxes imposed by the states, and the odd state and local luxury and excise taxes that are of growing importance. As long as the present exemptions under the federal income tax, estate tax, and gift tax remain at the present level, no burden on those in the lower brackets will result from these levies. In several cases the states have imposed an income tax with lower exemptions than that of the federal government, but as yet these taxes are not at high enough rates to be of much

significance<sup>32</sup> This statement assumes that the income, estate, and gift taxes paid by persons in the higher brackets are not shifted to the persons in the lowest income ranges. This assumption is made without hesitation as there seems to be almost universal agreement among the economists as to the validity of this belief and there is little reason to believe otherwise.

The extent of the burden imposed by the various taxes cited above is a question that may not be answered with a high degree of assurance. The burden is in no case certain, as it depends upon the assumptions made about the degree to which any of these taxes are shifted to the final consumer. Even in the case of the sales tax that is added on to the purchase price of the article when it is sold to the consumer, it is believed that the retailer or producer may be led, under certain conditions, to sell the article at a lower price (less tax) than he would have, had the tax not been imposed, thus absorbing a part of the tax himself. The extent to which a tax may be shifted depends on the market conditions prevailing at any particular time—the extent of competition or the lack of it, the nature of the consumers' demand for the article in question, general business conditions, the nature of the supply, and a host of other factors. There is little question, however, that in one way or another the consumer in all income brackets pays something more for many of the goods that he buys, because of the taxes imposed. Granting this fact, and the fact that the burden is of some significance, it is important to see if this burden is imposed with any respect for the requirement that the tax burden should assure equality.

First, it will be assumed that there is no problem of making allowance for individual differences in family responsibility. The problem then becomes one of determining whether or not the taxes on sales and excises assure equal treatment of persons with equal capacity at the start. According to the definition of capacity accepted above, this will require that persons with

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<sup>32</sup> In early 1938 there were 9 states with the exemption for the single man less than \$1,000, the lowest being \$500 in North Dakota. In 17 states the married exemptions were less than \$2,500, but in only 9 were they less than \$2,000. The rates on the first \$1,000 of taxable income are in the great majority of cases only 1 per cent. (See Strayer, Paul J., *op. cit.*)

equal incomes bear equal indirect tax burdens. For the purpose of illustration, the retail sales tax will be used to provide an example of the way in which the burden of this general type of tax is distributed.

The sales tax is a tax imposed at a flat percentage rate on the sales price of either all commodities or selected commodities. Assuming that the tax is shifted, to be subject to the tax the individual must make some purchase. The tax burden which results is therefore in direct proportion to the money value of the taxed articles that are bought. If the tax is a universal one, exempting no commodities, there will, therefore, be equality only if the money value of all the purchases of the persons with the same capacity are identical. If it is a selected tax, there will be equality only if the values of the purchases of the taxed commodities are equal in the case of persons of equal capacity. This is assuming that the amount of the tax that is shifted to the final consumer is the same in every case. If this is not true, there is no way in which the equality of the burden may be assured.

In addition to the problem of unequal shifting of the tax to the final consumer, there is the difficulty that the value of the taxed goods bought by persons with equal capacity is not always equal. Although there are definite patterns of consumption and spending that may be measured and determined for each income class, there may be considerable individual variation from the normal. In the income class of \$1,000 or less this may not be of great significance, however. Above this level when it is possible for larger savings to be made, at least for a short time, the variation becomes increasingly important, particularly for the persons in these classes that have few responsibilities. If the tax is imposed on selected commodities only, the chance for differences of this type are very much greater.

The federal excises are so restricted in number that the chance for inequality is even greater than in the case of the selected state sales tax. One example is the heavy excise on cigarettes. If a person is a smoker he will be subject to a greater burden than if a non-smoker, although the two individuals may have equal capacity. Once it may have been possible to justify this

type of discrimination on moral grounds, but this no longer seems to provide an adequate excuse. The spread of the smoking habit has been so great that the moral issue has little validity.

It was stated above that equality demanded that persons with equal capacity bear equal tax burdens but that it was necessary to allow for the fact that persons with equal money incomes had different responsibilities. This is particularly important in the lower income brackets, as the person with a small income will have a larger percentage of his income affected by this type of allowance than the person in the higher brackets; that is, if the allowance is to be confined to the essential differences, such as the fact that the person with three children has less capacity to pay than the person with none. Does the present tax system with its emphasis on the sales, customs, and excise levies in the lower brackets make the proper allowance, or is it possible to make the adjustment with a set of taxes of this type?

The sales tax will again serve to illustrate the way in which the various indirect levies are related to the individual. The possibility of an allowance being made for individual differences is dependent upon the relation of the value of taxed goods to the responsibilities of the individual. If the individual with the greater responsibility and therefore the smaller tax capacity bought fewer taxable goods, the requirement of allowance would be at least partially met. However, the tax is almost sure to operate in the opposite fashion. In the case of the general sales tax with no commodities exempt, the tax that is shifted to the consumer will be greater, the greater the total value of purchases. The larger responsibility usually means that there must be larger purchases. It is fair to conclude that instead of allowing for the fact that the taxpaying capacity is reduced by the additional responsibility, the sales tax and others of the same type may place a heavier burden on the taxpayer with the greatest responsibilities. Thus the tax burden of the least capable person is increased rather than reduced.

The various excises and sales taxes which exempt necessities have the same effect, but the exemption of essentials may make the discrimination against those in the lower brackets with extra

responsibilities less severe. The use of exemptions has not, however, been very great. The most productive excise of the federal government, with the exception of the liquor tax, is the tax on cigarettes and tobacco products. As the amount of tobacco used by the poor is substantial, the full effect of this discrimination is felt in the federal tax structure. The same lack of consideration for the fact that a tax on necessities is discriminatory is characteristic of the state and local tax systems. For example, the sales tax in the City of New York is applied to all purchases with the exception of food products. The majority of the state sales taxes are also inclusive, with exemptions either non-existent or very limited.<sup>33</sup> In conclusion it may be said that insofar as the existing indirect levies impose a burden on the person in the lowest income brackets, this type of levy cannot meet the requirement of equality. The importance of this type of tax is indicated by the fact that the Newcomer estimates show that in New York State the wage earner earning \$1,000 may pay as much as \$27 38 in indirect taxes to the federal and state governments, if it is assumed that all of these taxes are shifted to the final consumer. This estimate excludes the liquor tax and the payroll tax.

This review of the distribution of the tax burden in the lower income classes indicates that there is no doubt that the present tax system fails in practically every respect to make allowance for the difference in taxable capacity of the taxpayer and does not even assure equal treatment of persons with equal incomes before any allowance is made for different capacity. As long as this type of tax, which is now the backbone of the revenue system in the lower classes, remains in force it is believed that it will be impossible to correct this type of inequity. Although it is unreasonable to look for perfection in the tax system, the extensive discrimination in the lower brackets suggests that an attempt should be made to find some other means of raising the necessary revenue. The possibility of using the income tax with lower exemptions as a substitute is therefore a topic of some current interest in this regard.

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<sup>33</sup> Lutz, H. L., *op. cit.*, p. 635.



**Exemption of Subsistence Incomes.**—In the discussion of the requirements of the ideal system of tax distribution above, it was suggested that, if the point of view of the person considering the problem was such that the conscious guarantee by the government of a subsistence income was believed to be desirable for social and ethical reasons, the exemption of a subsistence income, however defined, would be favored. Although the tax literature on this subject is extensive, the definition of the term subsistence is notably lacking in the majority of the cases.<sup>34</sup> There are numerous family budget studies of typical wage earners, but the use of these figures for the purposes of setting the level of complete tax exemption has never been attempted. To avoid the vagueness that inevitably results from the use of the term subsistence without definite meaning, it is proposed that the point in mind can be made as well with the selection of an arbitrarily low figure as with a figure that is more nearly in conformity with the views of the welfare worker. It will therefore be assumed that the subsistence level for the average family is an annual income of \$800 and that the subsistence for the single person may not require more than \$300. The goal to strive for would be, therefore, the exemption of all persons with incomes below these levels from any tax contribution at all. The only significance of these figures is that they are so well below the level required by modern standards that there will be no dispute on this point and the entire attention of the reader may be devoted to the principles of taxation necessary to achieve even this slight concession for the less able.<sup>35</sup> It is to be remembered that this assumption—that the best system of tax distribution requires the exemption of subsistence incomes—is based entirely upon the consideration of the ethical or moral issues involved. The political wisdom of such

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<sup>34</sup> See Chapter 3.

<sup>35</sup> "A committee of home economists, representing public and private welfare agencies, informed the Greater New York Fund yesterday that a family of five in this city should have an income of at least \$1,248 a year. . . . Mrs. Luise K. Addiss, home economist of the Charity Organization Society and general chairman of the budget council, said that its figures embodied scientific knowledge of the needs of each member of the family, in conjunction with careful study of local prices, sound measures, and actual expenditures of real families." (*New York Times*, May 5, 1938.)

a policy or administrative considerations are notably absent from this conclusion.

In the previous section the answer to the question of the conformity of the existing tax system to this objective is found. The study of the distribution of the burden referred to indicated that even the farmer with an income of \$500, not all of which was received in cash, would have to pay in taxes an amount ranging from 12.0 to 19.1 per cent of his income in New York and from 11.2 to 15.6 per cent of his income in Illinois, depending on the assumptions made with respect to the shifting of the various indirect levies.<sup>36</sup> It was also concluded that not only was it true that everyone paid something in taxes, but that the burden was regressive in the income levels below \$2,000. The first possibility is, therefore, the modification of existing taxes to bring them into accord with the objective. This possibility may be disposed of at once. To relieve the poorest from all taxation would require that the tax on improvements be repealed, at least as it includes the homes and other properties used by this class, such as buildings where they purchase their goods, and would also require the repeal of the most productive excises and sales taxes that are now imposed by the federal and state governments. The only way in which the exemption may be provided is, therefore, by the drastic modification and complete revision of the existing structure. The possibility of such a revision will be considered below.

### **The Function of Lower Bracket Income Taxation in Achieving the Ideal Distribution**

The evidence presented indicates that, below the level of the existing income tax exemptions, the distribution of the tax burden fails to conform to objectives set up at the beginning of this chapter. Unless other techniques of taxation are used extensively, it will be impossible to bring the tax system into conformity with these objectives. Mere modification of the existing tax system is not satisfactory. However, it has been suggested that by the use of the lower bracket income tax the

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<sup>36</sup> See page 52.

same amount of revenue could be obtained and the ideal distribution of the burden maintained at the same time. The theoretical possibility of this program will be tested at this point. Practical limitations, particularly those of administrative and political significance, will be reserved for later consideration.

**Progression.**—The replacement of some of the excises, sales taxes, and the like, is a necessary prerequisite to the establishment of a progressive tax system in the lower brackets, granting that the same total revenue is to be raised. If additional revenue is needed, it might not be necessary to repeal existing taxes to achieve progression, as a progressive layer of income tax could make the total burden progressive. Such a layer would not, however, permit the full allowance for different responsibilities.

The theoretical advantages of the income tax as a means of assuring progressivity and obtaining the necessary revenue are obvious. Rates may be adjusted to meet the requirement of progression of any degree desired. By the lowering of the exemptions to a level where it is believed taxable capacity stops, the income tax may be so broadened in scope that it will make up for a part of the loss from the repeal of the old imperfect taxes. The rate scale can be adjusted to obtain the necessary balance.

The problem of estimating the extent to which the indirect taxes are shifted to the final consumer would vanish and there would be a new assurance in the determination of the exact amount that was being contributed by each individual to the support of his government. Not only would it be possible to assure progression, but it would be possible to maintain a consistent amount of progression at all times. One of the weaknesses of the present type of tax is that with changing market conditions it is generally believed that there are significant changes in the final incidence of the tax burden in the lower brackets. If the assumption of the non-shiftability of the income tax is correct, this uncertainty would cease to exist.

As far as this limited requirement is concerned, there seems to be no doubt that the income tax would be the logical choice. Flexibility and at the same time certainty could be achieved.

Differences between money income and capacity may be allowed for under an income tax more easily than under any other tax that is now in effect, if it is believed that there is need to use a more refined measure. It may be concluded, therefore, that in the use of the income tax the theoretical ideal of a perfectly progressive tax system may be fulfilled.<sup>37</sup>

**Equality.**—The second major requirement of a tax system distributing its burden in the proper manner was that the burden should be allocated with respect to the requirement of equality. Again the present tax system was found to fail to meet this objective. It was concluded that as long as the present emphasis on the indirect levies was maintained, it would be impossible to modify the existing tax structure sufficiently to assure even a very rough allowance for differing capacity and that, even in the case where the income and responsibility was the same, there were bound to be imperfections in the distribution of the burden.

The most notable advantage of the income tax is its adjustability to individual differences in capacity to the extent that is believed to be desirable and administratively practicable. It is generally believed to be the most refined, and the most susceptible to control, of all the tax instruments that are in use today. In the first place, the base of the income tax, net income, is a closer approximate to the generally accepted basis for taxable ability than any other single measure. In the second place, the individual is the basis of taxation rather than the sale of goods or the manufacture or distribution of goods. Even the fact that money income does not always include all real income that may prove taxable capacity need not be overlooked under the modern income tax. If, for example, the farmer receives an imputed income of \$200 a year from home-grown products used by his family, this figure may be added to the cash income figure and the total used as the net taxable income.

Although there are obvious limitations to the extent to which the individual adjustments could be made, the advantages of even rough allowances are great. Where the line would be

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<sup>37</sup> An example of the limitations of the discussion above is found in the fact that maintenance of local political independence is connected with the use of the property tax.

drawn is difficult to determine, but it is probably true that with the substitution of the income tax for various indirect levies there would be a greater demand for use of this type of allowance than there is at the present time. The conscious payment of the income tax by the average person would make him more aware of the discrimination between individuals than when the amount of tax paid is neither known nor related to any measure of capacity. Such expenditures as those for medical care and further allowances for children maintained in the higher educational institutions might be made fairly and effectively.<sup>38</sup>

One basis for the determination of the wisdom of making special allowances would be the amount of variation in the expense in individual instances. For example, the case for the allowance of medical expenses is based on the fact that these necessary expenditures may amount to a sum equal to the year's income in one case and to nothing at all in another. Although there are various ways to correct this unevenness directly through such schemes as group medical insurance or state medicine, as long as action along these lines is postponed there is need for the tax allowance.

It may be concluded that the income tax fulfills all the requirements of the criterion of equality. The only reason for not adopting the tax in the lower brackets would be that the administration of such a complex levy would be impossible on an equitable basis and that the administrative imperfection of a poor income tax would result in greater inequalities than a well-administered system of indirect taxes. This point will be considered below.

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<sup>38</sup> This question has already been a matter of discussion. A dispatch in the *New York Times* reports, "On the theory that a man's family is of as much importance as a man's cow, Senator Bone introduced a bill in the Senate today that would permit an income-taxpayer to deduct from his income tax the medical and dental expenses incurred by himself or family . . . It would also allow money spent for the education of a taxpayer's children to be deducted. . . . 'Senator LaFollette's purposes (sic) to amend the income tax laws so they will include smaller incomes which are not taxed under the present law. If Senator LaFollette's proposals are adopted it seems only fair to provide this very legitimate reduction for virtually necessary family expenses in order to protect those smaller incomes.'" (*New York Times*, August 22, 1937.)

**Basic Exemption.**—The final criterion of the ideal distribution of the tax burden was that the very smallest incomes should not be subject to any tax at all. This is difficult under any system of indirect taxation that is expected to produce much revenue. It is, however, relatively simple to make an allowance of this type under the income tax and be sure that the allowance is effective. The most difficult point is the determination of the level at which it is believed desirable to leave the individual free from any tax at all. One solution would be to follow the judgment of experts in medicine and public welfare work. They should raise the level of discussion above that of the ordinary political fight. However, there is no necessity that the sum suggested by this technical group be the one that is used for tax purposes. If there is a tendency to support the severe position taken by Taussig, the level might be below the level otherwise deemed desirable, or if the advantages of wealth distribution seemed particularly attractive, the level might be set well above that necessary for medical reasons. Although there are economic, administrative, and political considerations that should be taken into account, from the purely distributive side it is believed the best goal to work toward is that suggested above—the exemption of all incomes so small that, for the class as a whole, there is the necessity of a direct or indirect government subsidy to maintain the individuals at a level necessary for adequate support. It might even prove to be desirable to make some allowances for geographical differences in the cost of living.

A strong case is made in this chapter for the direct taxation of the small income. It is believed that progression throughout the entire tax structure is desirable, and that the use of the income tax in the lower brackets is the only way to assure this progression. Equality is considered a goal of importance, and it is believed that the income tax is the best way to be sure that the tax burden is distributed equally. It is believed that the tax burden should be placed on only income above the margin necessary for subsistence, and that this may be most easily achieved by the use of the income tax with exemption of the size believed to be sufficient. It is concluded, therefore, that the use of the

income tax on the small income is necessary to attain the goal of an ideal distribution of the tax burden.

At the beginning of this chapter, criteria to test the proper distribution of the tax burden were set up with the statement that it was necessary to have some basis for the criticism of the present tax system and the evaluation of the various alternatives. The tests chosen, however, are based in part on the particular prejudices of the writer although they conform to standards held by others. It is possible, therefore, that the selection of other criteria would lead to quite different conclusions. In view of this fact, it seems worth while to examine at least one of the other possibilities.

As long as it is believed that there are general governmental expenses that should be financed by the imposition of general taxes, the main propositions will hold. If, for example, proportionate distribution on the base of net income were considered the ideal, it could best be achieved by the use of a proportionate income tax. The necessity of the use of the income tax to achieve the goal of equality is almost as great with proportionate rates as progressive. Although the exemption of the smallest incomes might not be considered a desirable objective, the income tax could be imposed without any exemptions at all, and universal taxation of all incomes achieved without sacrifice of any principle. It is believed, therefore, that for the purposes of obtaining general revenues the use of the income tax is, in theory at least, demanded and is flexible enough to permit the attainment of different objectives.

The one case when the income tax is not the most desirable way of obtaining the revenue from those in the lower brackets is when it is believed that the burden of taxation should be distributed on the basis of the cost of the service provided or the value of the benefit received. Place for this type of taxation was recognized in the analysis of the issues presented above, but it is proper to recognize that the expansion of this type of tax distribution is desired by some and could be considered an objective quite as properly as any of those suggested above. On this basis taxable capacity would bear no relation to net income as such, although there might be a rough relation be-

tween the two as there is between the size of a home and an income. If carried through logically, in the lower brackets, it would mean that the burden would not necessarily be distributed equally on the base of income and would probably be regressive unless some rather arbitrary definitions of benefit were used to correct for increasing need for government assistance in the small income classes. For political, social, and economic reasons it is believed that this is not a goal that will receive much support in the years to come and may be thought of as a theory that has had its day in the past. It does, however, indicate the extent to which the tax chosen as ideal may be dependent upon the type of distribution believed the most desirable.

There are, of course, many other ways in which the distribution of the tax burden might be made. In most cases the income tax would be adjustable. It commends itself, however, particularly because of the fact that it is a tax paid directly by individuals and is a tax that cannot be shifted. In the chapters to follow an effort will be made to see if the income tax on small incomes is as desirable from other points of view.



## CHAPTER 5

### TAX CONSCIOUSNESS

The connection between the direct tax and tax consciousness is implied or directly stated in a large number of the recent references to the desirability of lowering the income tax exemptions. Although this idea is not new, it is a point that has received more attention in recent years than at any time in the past. In many cases it is the main argument advanced to support the recommendation that the direct tax be expanded to include the small income.

The references to the question of the direct taxation of small incomes found in the newspapers, magazines, and editorials indicate that tax consciousness is the point that makes the greatest impression on the layman and would be held by him as the most desirable result of the attainment of the broadened income tax base. Evidence of the widespread interest in this aspect of taxation is found in the fact that the Colwyn Committee on National Debt and Taxation<sup>1</sup> in England considered tax consciousness a goal of considerable importance and more recently the idea has received the blessing of Mr. Morgenthau, Secretary of the Treasury of the United States.<sup>2</sup>

The approach will be that of stating the objectives of tax consciousness before considering the possibility and effects of attaining it. The material available is such that in the consideration of various objectives much information relative to the other questions will be obtained.

#### The Case for Tax Consciousness

The case for equality in the distribution of the tax burden, considered above, was based upon the belief that equality was a goal worthy of working for in its own right. The case for the

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<sup>1</sup> See page 78.

<sup>2</sup> See page 82.

creation of tax consciousness is seldom put in these terms. It is usually considered as a means of achieving some further objective such as economy, honest government, or as essential to the preservation of a democracy.

**Political.**—The argument in favor of the increase of tax consciousness is frequently put in general terms with the emphasis on the necessity of maintaining a tax-conscious voter in a democracy. Variations of this theme are found in the literature of income taxation since it became an issue in this country. In their discussion of the income tax of 1894, Foster and Abbot held that

A far more serious objection to the income tax consists in the fact that its burden is confined to persons having an income of above \$4,000.00. It thus excludes from its incidence a larger portion of the population of the United States, and is in effect class legislation confined to those who, if not conceded to be wealthy, must at least be admitted to be well-to-do.<sup>3</sup>

Other discussion of the early income taxes in this country reveals the same concern on the part of those who are not entirely in favor of the measure. Soon after the amendment to the Federal Constitution was passed and the first income tax law under the amendment had been enacted, a paper presented before the American Academy of Political and Social Science contained a statement of the political issues involved that may be considered representative of much that has been written, both at the time and in the years since. The author believed:

There is danger in having a tax which already forms a substantial part of the income of our government, and which probably will be called upon to provide an increasing portion of the expenses of the nation, fall upon so small a percentage of the population. This tends to encourage extravagance in government, as legislators are more apt to incur additional expenditures when the revenue to meet them is secured by increasing the amount contributed by comparatively few of the people of the country, while they would be likely to hesitate to do so if this necessitated the placing of additional burdens upon the entire citizenship. But even a greater danger lies

<sup>3</sup> Foster, Roger, and Abbot, Everett V., *op. cit.*, p. 33.

in the very fact of the popularity of the tax among the great mass of our people through their escaping this form of taxation.<sup>4</sup>

A similar view was taken by Bastable who stated "the danger of relieving the lowest class of laborers from nearly all the burdens of the state while it holds preponderating power is apparent."<sup>5</sup>

In none of the examples cited is there definite reference to the desirability of the tax-conscious voter. It is evident, however, that this is considered desirable if the dangers of the class tax are to be avoided.

The definite connection between the development of tax consciousness and political power is made by Robert Jones. He stated his case in the following language:

If citizenship has in it, as most of us undoubtedly believe it has, some desirable possibilities in developing the human race, then for a government to abet, encourage or build upon the ignorance of its citizens in such a matter is as evil and vicious as for a despotism to abet, encourage or build upon the general ignorance of the masses of its subjects. It is not a good thing, but an evil thing, that people should be paying shillings in taxation whilst having a befogged idea that they are paying pennies. Let them know that they are paying shillings, and their interest in the matter of spending the shillings will be aroused. This may not always be to the taste of some politicians; but it will be of advantage to the body politic.<sup>6</sup>

A similar statement of the case for the tax-conscious voter is found in the writing of Robinson. His views are as follows:

In spite of the development of direct taxes, indirect taxes are still used in all tax systems. This retention is generally defended on the grounds that they are a means of reaching the poorer classes on whom it is difficult to levy direct taxes. In a democratic country it is argued it is essential for political security that all classes should be made to contribute to taxation . . . It may, however, be suggested that the method by which indirect taxes are paid through

<sup>4</sup> Schiff, Mortimer L., "Some Aspects of the Income Tax," *The Annals of the American Academy of Political and Social Science*, Vol. LVIII, March 1915, p. 17.

<sup>5</sup> Bastable, C. F., *op. cit.*, p. 319.

<sup>6</sup> Jones, Robert, *The Nature and First Principle of Taxation*, London, 1914, p. 207.

enhanced prices is not calculated to bring home to the taxpayer (more especially in the case of old taxes) the fact that he is contributing to revenue.<sup>7</sup>

More recently like views were advanced by John H. Williams. He stated,

. . . the relation between direct taxation and the franchise . . . is the essence of stability and permanence in republican governments. Without a close and obvious relationship between them the franchise is exercised without responsibility. The result is tyranny by a political majority.<sup>8</sup>

There are numerous other supporters of this doctrine among the academic fraternity,<sup>9</sup> and notice of the issue has been taken also by the practical man and the tax administrator. It is of interest that the last two investigations of the income tax in Great Britain both included references to the question of the need for tax-conscious citizens. In the majority report of the Colwyn Committee on National Debt and Taxation the following recommendation is made :

We consider it important on the broad grounds of citizenship that taxation should not be confined to a comparatively small section of the population. It would be a bad state of affairs if a large majority of citizens were themselves to make no actual tax contribution, and were to enjoy benefits provided entirely by the taxation of the few. Under conditions approaching the ideal—which would imply, *inter alia*, a satisfactory standard of living for the lowest-paid workers—all would make some contribution and would make it knowingly.<sup>10</sup>

Although the last Royal Commission on Taxation reporting in 1920 did not make specific recommendation in the final report, it did include reference to the question in connection with the

<sup>7</sup> Robinson, M. E., *Public Finance*, New York, 1922, pp. 41-42.

<sup>8</sup> From a letter of John H. Williams in the *New York Times*, January 2, 1937.

<sup>9</sup> See Stamp, Sir Josiah, *Problems in Finance and Government*, London, 1924, pp. 216-217; Lutz, Harley L., *op cit.*, pp. 472-473; Blakey, Roy G., *Taxation in Minnesota*, Minneapolis, 1932, p. 483; Buehler, A. G., *op cit.*, pp. 234-244.

<sup>10</sup> *Report of the Committee on National Debt and Taxation*, Cmd. 2800, London, 1927, No. 687, p. 239

consideration of the size of the exemption limit. The reference in the report is as follows :

On the other hand, the proposal has been made to us that the limit of the exemption should be lowered, this suggestion being coupled with a claim that the burden of indirect taxation resting on persons with small incomes should be lightened. It was advocated by one witness that every income, however small, should be liable to Income Tax, not primarily for the sake of revenue to be obtained in this way, but as a means of effecting other political ends, and several witnesses have depreciated the establishment or the continuance of a position that would absolve the majority of the voters of the country from any direct payment towards the country's expenses, especially in the present condition of the national purse.<sup>11</sup>

In the United States the general political argument in favor of tax consciousness is favored by various groups but usually the issue is met more directly and the specific arguments in favor of the tax-conscious citizen are advanced. One important organization that has favored the creation of tax consciousness for political reasons is the Institute for Government Research of the Brookings Institution. In one of its recent state studies it held that,

One serious defect of the American tax system is the small proportion of the voting population which is required to pay a direct tax for the support of the governmental activities. The few pay directly and feel the impact of the changing expenditures which the many vote. Through a general personal income tax only can even a partial correction of this political weakness be effected.<sup>12</sup>

The similarity of the points of view noted above is evident. Without exception the primary concern of the writers is the danger involved in the fact that the majority paying little in taxation, and not fully aware of that which they do pay, will use its power carelessly and to its own moral disadvantage or to the definite disadvantage of the minority with the money who

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<sup>11</sup> *Report of the Royal Commission on the Income Tax*, Cmd 615, London, 1920, p. 55.

<sup>12</sup> The Institute for Government Research of the Brookings Institution, *Report on a Survey of Administration in Iowa, The Revenue System*, Des Moines, Iowa, 1933, p. 123.

pay the bills. To those who have been brought up in the democratic tradition this argument is appealing and carries much weight. The common interest of all members of a democracy in the support of the best possible government is a basic assumption of democracy and the rise of special interests, although not uncommon, is always looked upon as detrimental to its best interests. In the next few pages some of the specific issues that are of concern to those who are advocates of tax consciousness will receive attention.

**Expenditure Control.**—The severe and prolonged depression which the United States has suffered in recent years, the accompanying increase in federal expenditures, and the continuing deficits have focused the attention of many persons on the possibility of devising some effective means of expenditure control in a democracy. The need for intelligent control is not new, but interest in this problem has naturally grown with the size of the national debt and the tax burden. It is, therefore, only logical that the aim of the majority advocating the development of tax-conscious citizens has been the reduction of expenditures or the prevention of further increases in expenditures. References to the possibility of gaining control in this manner have been so frequent that it would be of no particular advantage to endeavor to include them all. In many cases, the reference is casual and not revealing of the exact nature of the issues involved.

It is again of interest to note that the Colwyn Committee sitting in England in 1927 considered this issue of sufficient importance to include in its final report. The Committee held that,

It appears to us that it would be damaging to the sense of responsibility in an electorate that a large section should be able to vote for some perhaps expensive policy, feeling all the while that, because they were not personally liable to taxation, the expenditure would not touch them in any way. It is sometimes argued that the poor, since they are the first to suffer from bad legislation, would not be likely to vote irresponsibly even if entirely immune from taxation. This argument seems, however, to be defective, for the cause

of suffering may not be clear; moreover, we have to consider, besides legislation which is positively bad, legislation the benefits of which, although real, do not sufficiently outweigh the damage done to the community by the attendant taxes—in other words, legislation which is “bad value for money”<sup>13</sup>

The Brookings Institution also supports its stand for tax consciousness for general political reasons, with the specific argument that it is necessary for the purposes of expenditure control. It believes that,

With the rising tide of governmental expenditures, emphasis has been focused on the lack of balance between the distribution of governmental services and the distribution of governmental costs. In voting expenditures each qualified voter has an equal vote, but tax systems have rested on a narrow basis in that they reach directly only a small minority of the qualified electors. The conviction has therefore developed that the base of the state tax systems must be broadened so as to bring within their scope all or a majority of those who control governmental expenditures. This is necessary if the voters are to be made tax conscious and given a personal stake in the finances of government. Under a representative government sound governmental finance can be maintained only if the relationship between expenditures and tax burdens is brought home directly to the individual citizens who in the last analysis determine the actions of their representatives.<sup>14</sup>

An important reference to the belief that an increase in tax consciousness would be desirable for purposes of expenditure control is found in the report of the Committee on Taxation of the Twentieth Century Fund; in its report the Committee said,

Everyone in the United States should be made conscious of the fact that, if he wants government services, he has to pay for them. The well-to-do may properly be asked to cover a large share of the government's costs, but nobody should expect to go “scotfree” unless perhaps he is completely dependent on the government.<sup>15</sup>

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<sup>13</sup> *Report of the Committee on National Debt and Taxation, op. cit.*, pp. 239-240.

<sup>14</sup> The Institute for Government Research of the Brookings Institution, *Taxation of the State Government of Alabama*, Vol. 4, Part 3, of a “Report on a Survey of the Administration of the State and County Governments of Alabama,” Montgomery, Alabama, 1932, p. 458.

<sup>15</sup> *Facing the Tax Problem, op. cit.*, p. 457.

Special reference should also be made to the recent statement of the Secretary of the Treasury, as it is not altogether in keeping with the generally accepted belief of the attitude at Washington. In a public address during the winter of 1937-38, Mr. Morgenthau said,

We would be applying the principle of capacity to pay more justly if we were to reduce the number of consumer taxes and at the same time to increase the number of income tax payers. Tax-payers who are squarely confronted with their own tax burdens are bound to be keenly alive to the way the money is being spent by their government.<sup>16</sup>

An indication of the extent of the popular interest in the question is found in the fact that numerous editorials have been written on the desirability of creating tax consciousness, and that a recent issue of *Editorial Research Reports* devoted to the question of broadening the income tax base mentions the hope that a broader income tax base will result in an increase in tax consciousness as one of the chief arguments in favor of the proposal<sup>17</sup> There are also numerous articles that include reference to the need for the development of tax consciousness to prevent greater extravagance.<sup>18</sup>

In the newspaper files, however, the most frequent mention of connection between tax consciousness and expenditure control is that made by the business organizations and the bankers. Within the past two years references to the subject have been made by the Guaranty Trust Company of New York,<sup>19</sup> George

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<sup>16</sup> Address of Secretary of the Treasury Morgenthau before the Academy of Political Science, November 10, 1937 (*New York Times*, November 11, 1937.)

<sup>17</sup> See *New York Times*, May 4, 1937 and April 17, 1937; also Patch, Buel W., "Broadening of the Income-Tax Base," *Editorial Research Reports*, Vol. II, No. 17, November 5, 1937.

<sup>18</sup> See Magill, Roswell, "The Co-ordination of State and Federal Taxes," *The Tax Magazine*, Vol. 15, No. 4, April 1937, p. 187; LaFollette, Senator Robert M., Jr., "Taxes Should Be Higher—But Fewer and Direct," *The Saturday Evening Post*, Vol. 210, No. 50, June 11, 1938, p. 23; Brindley, John E., "Net Income and Retail Sales Taxes of Iowa," *Bulletin of the National Tax Association*, Vol. XXII, No. 3, p. 69; Strangman, H. Arnold, "Taxation of 'Lower Bracket' Incomes," *The Tax Magazine*, Vol. 14, No. 6, June 1937, p. 331; *Tax Policy*, Vol. IV, No. 6, April 1937, *passim*.

<sup>19</sup> *New York World-Telegram*, June 27, 1938.



V. McLaughlin, president of the Brooklyn Trust Company,<sup>20</sup> Orval W. Adams, president of the American Bankers Association,<sup>21</sup> the conference of "small business men" called to Washington by President Roosevelt,<sup>22</sup> and the New York Board of Trade.<sup>23</sup>

In a large percentage of the cases the wish for economy seems to be the father to the thought that the creation of a tax-conscious citizen would result in the curtailment of expenditure. In most instances no consideration is granted to the multitude of factors that are of importance in the attainment of the desired result. As will be suggested below, the possibility of success is dependent upon the effective presentation of the case for economy in specific instances. It should also be noted that much greater concern is expressed over the federal budget than over the state and local budgets. Although this is the natural result of the fact that federal expenditures have grown more rapidly than the expenditures of the other governments and the rising federal deficit, it is still important to consider the possibility of control over the expenditures of the state and local spending machines.

**Other Goals.**—The hope that the creation of tax consciousness will result in the improvement of the democratic process and, more specifically, in the reduction of expenditure is in the minds of practically all persons whose advocacy of this policy has come to the attention of the author. There are, however, some more definite political results that are believed to follow. One that is particularly appealing at the present time is the suggestion that the creation of tax consciousness and the resulting concern over the way in which the government revenues are spent will result in the prevention of war. Reference to this belief is found in two places. Professor Weeks, at the time of the World War, wrote,

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<sup>20</sup> *New York Times*, April 29, 1937.

<sup>21</sup> *New York Times*, May 14, 1938.

<sup>22</sup> *New York Times*, February 4, 1938.

<sup>23</sup> *New York Times*, January 18, 1938.

What changes would follow the translation of every indirect tax into direct taxation! Then the seemingly sourceless money so prodigally spent on battleships would seem to be dug out of the private purse, and peace would be popular.<sup>24</sup>

The other reference is found in the testimony of a witness before the last Royal Commission on the Income Tax in England. It was held that "if people realize that war will entail a heavy burden, they will hesitate before having recourse to arms." <sup>25</sup> No doubt other persons who are writing about the desirability of tax-conscious voters from the new awareness of the voter of the fact that it is his money that the government spends. They have not, however, been as bold as the two individuals referred to above.

The increase of tax consciousness in the lower brackets is favored by some persons who believe that if this were to be assured, the high-bracket taxpayers would bear their burden with better grace than is often the case in the United States. This viewpoint was expressed to the author by officials concerned with the administration of the income tax in England. They held that one of the primary reasons for the maintenance of the income tax on the low income classes was the fact that it made it possible to tell those with large tax liability that, as long as all groups had to pay their share, there was no legitimate complaint to be made against the high rates for which they were liable. As it has been customary to have rate changes apply to all income taxpayers, large and small, the large taxpayer has found comfort in the thought that the little fellow suffered along with the big. The importance of this argument is emphasized by the fact that in England, as well as in the United States, the cooperation of the taxpayer is necessary for the successful administration of the income tax in the higher brackets.<sup>26</sup>

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<sup>24</sup> Weeks, Arland D., *The Psychology of Citizenship*, Chicago, 1917, p. 130.

<sup>25</sup> Statement of Mr. J. Ralph Dagg, *Minutes of Evidence*, Royal Commission on the Income Tax, Cmd 288-8, London, 1919-20, No. 20, p. 805.

<sup>26</sup> In a recent article Senator LaFollette also makes the point that in England the large taxpayer is made more willing to bear his load as a consequence of the direct burden placed on the little fellow. He says, "There can

In the references to the problem of the creation of more tax consciousness in the United States it is assumed apparently that the taxes now imposed do not stimulate the voter to concern himself with government reform and expenditure reduction. As this is merely stated as a fact or implied in the statements referred to above, it will next be necessary to ascertain the extent to which this is true.

### Present Status of Tax Consciousness

To measure tax consciousness accurately it would be necessary to make an extensive sample study of the population on some objective basis. Unfortunately the resources with which such a study could be made are not available to the writer. It is also extremely doubtful if it would be possible to isolate the one factor of tax consciousness from the other factors that make up the total reaction of the citizen toward his government. It is generally agreed, however, that there are certain taxes that promote tax consciousness and others that are less likely to do so. This precludes the possibility of measuring the extent of tax consciousness resulting from the impact of the tax system as a whole. It is still important, however, to estimate the number of people who may feel each tax if a change in the tax system is to be contemplated.

In the first place, it is believed that a tax which is paid directly by the person bearing the burden is more likely to result in the realization of the fact that the government, whatever else it may be thought to be, is also a source of expense. Although it is not impossible to have tax consciousness with a system entirely dependent upon indirect taxes, if an extensive publicity campaign is carried on, the direct payment of a tax to the government collector is more likely to result in the effective dramatization of the cost of the government and will probably have more

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be no doubt that the high-bracket taxpayers in Great Britain have accepted their heavy burden with much more grace than have our taxpayers similarly situated, because the British upper-bracket taxpayer knows that his fellow citizens with comparatively smaller incomes are carrying their fair share of the load" (LaFollette, Senator Robert M., Jr, *op cit*, p 32.) It seems likely that he has talked with some of the same officials who were kind enough to advise the writer of their reaction to the situation as it existed during the winter of 1936-37.

lasting effects. A difficulty in the development of tax consciousness with the use of an indirect tax is that, although it is possible to make known more certainly than is the case today that in the price of a package of cigarettes or in the rent paid for one's house there is included a tax which is shifted to the consumer, it is impossible to say in each case the exact amount of the tax that has been shifted.

Other points that are believed to be important are suggested in the conclusions of the recent Twentieth Century report on taxation. The conclusion reached is that:

To be effective, however, it (tax consciousness) has to make the taxpayer aware of the different levels of government, so that, for example, he will not attribute to the federal government chief responsibility for the weight of the real estate tax. It also has to show the taxpayer a connection between amount of expenditures and amount of tax. A flat tax, which does not vary even though governmental expenditures change, shows no such connection.<sup>27</sup>

Although it seems plausible to reason as is done above, there is no assurance that even the direct, variable tax will lead to a marked degree of tax consciousness. Lutz emphasizes this point in the following statement:

The existence of tax consciousness, which is a state of mind, is not always easily established; . . . While there is presumption that direct taxes are more likely than indirect taxes to induce tax consciousness, the connection is not inevitable. Direct taxes have not always produced it, or a reaction that would indicate its existence, expressed either as a criticism of expenditure or of general governmental policy. The apathy of property owners to rising local expenditures and taxes is well known, as is their indifference to the sources of governmental waste and inefficiency.<sup>28</sup>

There still remains, however, the presumption in favor of the direct, variable tax, and it is proposed that it is sufficiently realistic to warrant its use as a test of the degree to which the present tax system may be expected to make the taxpayer realize the amount of his contribution to the public treasuries.

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<sup>27</sup> *Facing the Tax Problem, op. cit.*, p. 421.

<sup>28</sup> Lutz, H. L., *op. cit.*, pp. 690-691.

**In Local Government.**—In the local tax systems the property tax is the only important source of locally-collected tax revenue<sup>29</sup> This tax ranks high on the list of those suited to promote tax consciousness. Paid directly to the local government, it will also vary in amount with the size of the local budget. It is the usual practice to set the local property tax rate by figuring the amount of local expenditures to be financed by this levy as a percentage of the total assessed valuation of the property in the community.

Although the property tax promotes tax consciousness on the part of those who pay this levy, its effects in this regard are of course restricted to the owners of property in the local political units. Tenants paying a part of the property tax in their rent are not made conscious of the tax in the same way as the home owner who has to meet his tax bill at least once a year. It is estimated that only about one-half of the families in the United States own their own homes.<sup>30</sup> It may be concluded that, although the property tax is a good promoter of tax consciousness, its scope is limited and will not assure the uniformity of tax consciousness that is believed to be desirable by the advocates of this doctrine.

Additional limitations arise from the fact that homestead exemptions<sup>31</sup> and the tendency for the less well-to-do to rent in a higher percentage of cases than the more wealthy, prevent the property tax from developing tax consciousness among the persons with small incomes. Thus, although it would not be of very great importance if half of all income classes were free of any property tax paid directly, the lack of payment may become of considerable importance if only 10 per cent of the poorest third of the population are aware of the direct property tax. The failure of a particular group to realize the connection between expenditures and taxation may well make them a powerful pressure group ignorant of the price they are paying for special benefits obtained. Although it is impossible to determine

<sup>29</sup> See page 58.

<sup>30</sup> *Statistical Abstract of the United States, 1937*, Table 44, p. 51, and Table 568, p. 589.

<sup>31</sup> Twelve states had some type of homestead exemption as of August 15, 1937. (*Tax Systems of the World, op. cit.*, p. 152.)

the percentage of the persons with incomes below the present federal income tax exemptions who are made conscious of taxation by the local property tax, it is safe to say that it is considerably less than 50 per cent.

The remaining taxes used by the local governments, although not of very great importance, should be included in this review of tax consciousness on the part of the member of the town or city. The only one that is believed to promote any extensive tax consciousness is the sales tax used by the cities of New York and New Orleans.<sup>32</sup> This tax, paid by the consumer as a separate part of the total price that he must pay for retail goods, is believed to result in a considerable amount of tax consciousness. It is paid many times, perhaps several times a day, and is paid by rich and poor alike. It does not, however, usually vary in amount with the change in the expenditure of the city, although this is possible. Its inclusiveness is a strong point in its favor as is the fact that it is paid many times in a year. It is believed, however, that the very fact that it is paid so frequently and, as a consequence, in relatively small amounts each time, is a factor working against the promotion of the maximum amount of reaction on the part of the taxpayer. Once it becomes customary to pay a few cents extra with each purchase it may become a fixed habit and be forgotten by the taxpayer unless brought to his attention by the retailer or through a well-organized campaign of some interested group. It is also true that the practice of charging the tax separately may not be the uniform practice. Instances have come to the author's attention where New York retail stores have abandoned the practice. If this practice is general, it will reduce the resulting tax consciousness.

The remaining sources of local revenues are miscellaneous fees and charges for the privilege of engaging in certain types

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<sup>32</sup> The situation in Philadelphia is uncertain at the time this is written. A city sales tax was vetoed by the Mayor in January. The veto was sustained by the Council. It is of interest, however, that the City Council passed a city income tax of  $1\frac{1}{2}$  per cent on earned income in excess of \$1,000, in November 1938. The State Supreme Court held that the exemption provided was unconstitutional and the City Council repealed the measure in face of the widespread protests against the flat rate tax without exemptions. (See *New York Times*, November 27, 1938, December 6, 1938, and January 6, 1939, also *Tax Policy*, Vol. VI, No. 4, February 1939, p. 29.)

of activity or in enjoying special benefits granted by the city. These charges and fees are usually paid by business men and are often small in amount. The possibility of their being shifted and their direct connection with the benefits or privileges enjoyed makes it extremely doubtful whether they add materially to the tax consciousness of the local taxpayer.

As far as the local governments are concerned, it may be concluded that although there is considerable tax consciousness, there is less in the low income brackets than in the high. The possible exceptions to this conclusion are in New York and New Orleans where the retail sales tax may be counted on to promote an indefinite amount of additional response, particularly in the lower brackets.

**In State Government.**—In the state tax systems the tax most certain to result in tax consciousness is the personal income tax. This tax, paid directly and possibly varying in amount with the size of the expenditures, is certain to make those who pay it aware of the costs of government. Its great weakness is the fact that it is paid by a very small percentage of the voters. In the first place there are 17 states that do not have full personal income taxes, these including some of our more populous states, such as Pennsylvania and New Jersey.<sup>33</sup> In the second place, all of the states using the personal income tax as a part of their tax systems have found it expedient to grant sizeable exemptions to the poorer taxpayers. The exemption for married persons is \$2,000 or more in all but 10 of the 31 states that have full personal income taxes, and \$2,500 or more in 13 states<sup>34</sup> When it is realized that all of the states grant an exemption for dependents of at least \$200, it becomes obvious that even in the states that use the direct personal income tax, the number of taxpayers is so few that the tax consciousness that results is limited to a very few persons in the upper income brackets<sup>35</sup>

<sup>33</sup> *Tax Systems of the World, op. cit.*, pp 137-138.

<sup>34</sup> *Ibid*

<sup>35</sup> For this reason and also because of administrative difficulties, the percentage of the total population liable to income tax is very low even in the states with the smaller exemptions. In Mississippi, with exemptions of \$750 for a single person, \$1,500 for the head of a family, and \$200 for each dependent, there were in 1936 only 11,558 income taxpayers out of an adult

The only other tax paid directly by a large number of state taxpayers is the passenger automobile license. It is possible that with a total of 24,197,685 passenger automobiles registered on December 31, 1936, 15,000,000 to 20,000,000 families own at least one car each<sup>36</sup> Thus it may be fairly estimated that from one-half to two-thirds of the 30,000,000 families in the United States pay a yearly automobile registration fee.<sup>37</sup>

It is difficult to estimate the amount of tax consciousness promoted by this tax. It is large enough to make the average car owner think about it, ranging as it does from about \$3 to \$15, but its direct connection with the ownership of a car and the possible connection in the mind of the taxpayer with the cost of the plate or the special benefits provided by the state to the car owner would seem to lessen its effectiveness as a tax useful in the promotion of general tax consciousness.<sup>38</sup> Another weakness is the fact that it is seldom changed in amount from year to year, the flat rate remaining the same as long as the same type of automobile is owned.

As with the property tax paid to the local government, whatever tax consciousness is developed by the automobile registration fee is not as great in the low income brackets as in the high. The percentage of persons with incomes of less than \$1,500 who own automobiles is not definitely known, but it is certain that it is not nearly as great as for persons with incomes above that

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population of 1,031,547. (Source: Letter from Leigh Watkins, Jr., Director of Research, State Tax Commission of Mississippi.)

In North Dakota, with exemptions of \$500 for a single person, of \$1,500 for the head of a family, and \$200 for each dependent, there were in 1935, 14,157 taxable returns out of an adult population of 358,182 (Source: Letter from V. L. Gilbreath, Income Tax Deputy, State Tax Commission of North Dakota.)

In Idaho, with exemptions of \$700, \$1,500, and \$200, there were in 1935, 16,723 income tax returns out of a total population of 246,770. (Source: *Fifth Annual Report*, State of Idaho, Department of Income Tax, p. 5)

In each case the adult population figures are those of the 1930 Census. The total is that of all persons over 21, regardless of color. (See *Fifteenth Census of the United States, 1930*, "Population," Vol. III)

<sup>36</sup> Automobile Manufacturers Association, *Automobile Facts and Figures*, New York, 1937, p. 3.

<sup>37</sup> The Census of 1930 gives the figure 29,904,663 as the total number of families in the United States. (*Statistical Abstract of the United States, 1934*, Table 40, p. 48.)

<sup>38</sup> *Facing the Tax Problem*, op. cit., p. 353.



level. In the very lowest ranges it is probably the exceptional family that owns an automobile, in spite of the fact that there are men on relief who drive to collect their checks. This means that again there is a fairly homogeneous group at the bottom of the income scale that is free from tax consciousness and can ask for special benefits without seeing that there is any connection between them and the tax bill paid.

Another state tax which generates tax consciousness among this group of car owners is the gasoline tax. Levied in all of the 48 states, it has been producing increasing amounts of revenue in recent years. Rates vary between two and seven cents a gallon.<sup>39</sup> Although the tax is collected from dealers and added to the price of the gasoline sold to the consumer, the usual practice of stating the tax separately in the final price should make the purchaser aware of it. The consciousness resulting has probably been diminished, however, as at the time the gasoline tax rates were increasing the price of the product to the dealer was decreasing.

It is believed that the only other state tax promoting extensive tax consciousness is the retail sales tax. Although this is an indirect tax, if added to the sales price of an article as a separate item it will certainly be noticed by the taxpayer.<sup>40</sup> This is a requirement in over half of the 29 states with sales taxes and is the practice in a few of the other sales tax states.<sup>41</sup>

As 19 of the states do not use this tax, it still leaves a large

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<sup>39</sup> See *Tax Systems of the World, op. cit.*, pp. 168, 224, 392; cf., *Facing the Tax Problem, op. cit.*, p. 360.

<sup>40</sup> Several of the state tax officials in states where there is both a sales tax and an income tax with relatively low exemptions believe that the sales tax develops more tax consciousness than the income tax.

Leigh Watkins, Jr., Director of Research, State Tax Commission, Jackson, Mississippi, writes: "I think possibly that the sales tax, because of its daily widespread applications, has done more to engender thought as to taxation than anything else." (Letter to the author, May 14, 1937.)

Ellis D. Beyer, Director, Income Tax Department, State Tax Commission, Topeka, Kansas, writes: "My recent trip relative to the sales tax, however, convinces me that it will have far more effect on tax-consciousness than the Income Tax Law. I made a similar trip over the state four years ago explaining the Income Tax Law. The number in attendance at these meetings for a discussion of the sales tax has been three or four times as large in each city as the similar meeting four years ago relative to the income tax." (Letter to the author, June 8, 1937.)

<sup>41</sup> *Tax Systems of the World, op. cit.*, pp. 153-156.

percentage of state residents without the scope of its influence. Other disadvantages are the fact that it is paid in small sums day by day and does not vary directly with expenditures. However, it has the decided advantage of being paid by all, rich or poor, in the states where it is used

Other taxes that are used extensively by the states are the various business taxes that are paid directly by only relatively few individuals, and the property tax. As the state property tax is now becoming of less and less importance in the extent to which the states use it and in the portion of state revenues obtained in this way, it does not any longer assume an important role in the creation of tax consciousness.<sup>42</sup> The various business taxes promote some tax consciousness, but the business man will be made less conscious than would be the case otherwise to the extent that he believes that he can shift the tax in the form of higher prices.

One tax that is used by a growing number of states and is a possible source of tax consciousness is the state cigarette tax when the state stamp placed on each package states the amount paid.<sup>43</sup> This tax reaches a large part of the population and does not exempt the poor. It is weakened, however, by the fact that it is usually maintained at a fixed rate year by year.

Special notice should be taken of the state poll tax. Although it produced only 14 per cent of total state revenues in 1937,<sup>44</sup> and is often thought of as a dead carry-over from the past, it is still levied in 25 states.<sup>45</sup> In a few states, mostly in the southeastern section, it plays an important part in the revenue system.<sup>46</sup> It is, however, not of any general importance in the promotion of tax consciousness. This is primarily due to a lax administration which has resulted in its becoming, to a large extent, a voluntary payment.<sup>47</sup> Other factors which lessen its

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<sup>42</sup> The state property taxes produced only 7.96 per cent of total state revenues in 1937. (See *Tax Policy*, Vol. V, No. 1, November-December 1937.)

<sup>43</sup> 21 states now tax cigarettes alone or cigarettes and other tobacco products. (*Tax Systems of the World*, *op. cit.*, pp 158-159.)

<sup>44</sup> *Tax Policy*, *op. cit.*

<sup>45</sup> *Tax Systems of the World*, *op. cit.*, p. 391.

<sup>46</sup> Lutz, H. L., *Public Finance*, *op. cit.*, p. 463.

<sup>47</sup> *Ibid.*, p. 466.

importance are its size; it is usually a nominal charge of from \$1 to \$5, and the lack of any variation in the amount of the tax with the rise and fall in expenditures. It is a suffrage prerequisite in 14 states,<sup>48</sup> but whatever value it might have has been lost by lax administration.<sup>49</sup> The use of the poll tax to help finance old-age assistance and pension plans indicates, however, that it is still considered a useful tax in some areas.<sup>50</sup>

It may be concluded that if all state residents are to be made tax conscious in the true sense of realizing the connection between the costs of state government and the state tax, it will be necessary to modify the state tax system. Although it is likely that the tax consciousness of the relatively wealthy is already developed as far as taxes alone can develop it, it is believed that the lower in income scale one goes the less effective is the present state tax system in developing the tax-conscious mind. This is believed to be true in spite of the large percentage of the state residents who pay for automobile licenses.

**In Federal Government.**—Consciousness of the taxes necessary to support the federal government is chiefly the result of the imposition of the federal personal income tax. As has been suggested above, the income tax is the ideal instrument for the development of this state of mind. However, with the federal exemptions at their present levels of \$1,111 for the single man, \$2,778 for the head of a family, and \$400 for each dependent, the percentage of adults made to pay this tax is relatively small. In 1936 the total number of returns was about 5.4 million, of which some 2,861,108 were taxable.<sup>51</sup> Thus only about 9.5 per cent of the 30 million families in the United States were subject to the federal personal income tax.<sup>52</sup> This leads therefore to

<sup>48</sup> *Tax Systems of the World, op. cit.*, pp. 174-175.

<sup>49</sup> "Even where the poll tax is made a franchise prerequisite, only a relatively small proportion of the taxable polls is reached." (The Institute for Government Research of the Brookings Institution, "Report on a Survey of Administration in Iowa," *op. cit.*, p. 88.)

<sup>50</sup> The states are Connecticut, Michigan, and Nebraska. (See *Tax Systems of the World, op. cit.*, pp. 174, 175.)

<sup>51</sup> *Statistics of Income for 1936, Part I, p. 4.*

<sup>52</sup> This figure is higher than it should be because of the fact that more than one return may be filed by a single family. It also varies with the year chosen. In 1934 there were only 1,795,920 taxable returns or 6 per cent. (See *Statistics of Income for 1934, Part I, p. 22.*)

the conclusion that persons made tax conscious are a definite economic class and that the majority of those who have the power to vote and thus, in theory, to control federal expenditures are entirely free of any direct obligation.

The only other federal tax that is believed to lead to tax consciousness is the tax on wages in certain employments to finance the old-age pensions payable under the Social Security Act. Although the number of persons subject to this tax is much larger than originally anticipated, due to the large number who work part of the year in covered employments, the tax consciousness generated is limited by the fact that the direct connection between the payment of this tax and the eligibility for old-age pensions may distinguish the payment in such a manner that the taxpayer will not think of it as a contribution to government for general purposes but simply as an enforced insurance payment for his own benefit.<sup>53</sup> The fact that the employer deducts the tax from the wages paid is also a factor which may lessen the extent of the tax consciousness on the part of the employee.

Other important sources of federal revenue are the liquor taxes, tobacco taxes, customs duties, and the various excises and stamp duties. None of these taxes is now imposed in a manner that is calculated to create tax consciousness. Although it is possible that the cigarette tax might be stated in such a manner that the purchaser would be aware of the amount he is paying on each package, this is not done at the present time. The revenue stamp used on each package of cigarettes simply states that the package contains twenty Class A. cigarettes and that the "U. S. I. R." has something to do about it. It would not be surprising if the majority of smokers thought that the manufacturer placed the stamp on the package to hold the top closed and permit the convenient practice of opening only one corner.

Customs duties and the other taxes are usually paid by the

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<sup>53</sup> The Social Security Board makes the following report: "It had been estimated in advance that the old-age insurance system would cover some 25 or 26 million full-time jobs. The difference between the estimated number of jobs and the estimate of 32 million or more individuals who received taxable wages in 1937 is to be accounted for largely by labor turn-over." (*Third Annual Report of the Social Security Board, Fiscal Year Ended June 30, 1938*, U. S. Government Printing Office, Washington, D. C., 1938, p. 30.)

business man and added on the final selling price of the article whenever possible. Although the individual business men who pay the tax are made aware of the fact that it is imposed and must be paid by someone, they are relatively few in number and would have less concern than the direct taxpayer insofar as they believed that they could shift the burden to the consumer or purchaser of their product.

If it is true that little tax consciousness results from the imposition of the Social Security tax, it may be concluded that the amount generated by the federal tax system is slight and that there is a large section of the population, as determined by the size of the income tax exemptions, that is free from any tax calculated to promote it. In this respect the federal tax system is worse than that of the local governments and a large number of the states.

### **Taxation of Small Incomes and Tax Consciousness**

In many of the references to the desirability of the creation of tax consciousness it is suggested that the direct taxation of small incomes is the best way to attain the desired goal. It seems difficult to disagree with this point of view. There are, however, certain requirements that must be fulfilled if this tax is to promote the maximum amount of tax consciousness.

As it is evident that the creation of tax consciousness is dependent upon the full realization of the taxpayer of the total amount of his obligation to the government, the most important factor is the way in which the tax is paid. An indirect tax paid in the price of a good may create no tax consciousness in itself, whereas a tax of equal size paid directly will create at least some tax consciousness. However, even with the use of a direct tax, the amount of reaction is determined to a large extent by the way in which the tax is collected.

In the case of the income tax it is often thought that there is only one way of administering the tax. This is not necessarily true of the tax when applied to the lower brackets. Various alternative ways of collecting the tax are available to the government. Two broad classifications are suggested; one, the type

of tax where the payment is made by the taxpayer directly to the government in question; the second, where the amount of the tax determined is deducted at the source, usually, in the case of the low income brackets, by the employer. The tax deducted at the source is a much less effective means of promoting the desired tax consciousness than is the tax paid directly. This is true because the conscious saving required to meet a tax bill is much more likely to impress the fact of payment on the mind of the taxpayer than is the receipt of a wage check of an amount smaller than normal. It is possible that after the novelty of the new deduction from wages had had a chance to wear off, it would be accepted as a matter of course and the tax consciousness reduced to a minimum.

To promote the maximum consciousness the tax should also vary in amount as different expenditure policies are followed by the government in question. This suggests that a poll tax or filing fee, required regardless of the size of the income, are not as good as the straight income tax with the expectation of varying rates from time to time and varying liability as income fluctuates. The nominal amount that is usually set for a flat payment of this type is also a factor in lessening its effectiveness. Although it is not absolutely necessary to limit the charge to a dollar or two, the political and practical administrative limits are probably reached at this point, to say nothing of the obvious distributional inequities that the flat charge per head is sure to engender, which are more acute as the size of the charge becomes greater.

The attainment of universal tax consciousness is desired by the great majority of the sponsors of the idea. It is claimed that if the idea is to be carried out to the point where it is really an effective means of attaining the ends desired, all persons, rich or poor, should be made equally conscious of the costs of government. If this is to be done by the use of an income tax, all persons must be included within its scope regardless of the size of their incomes. Although this is the ideal, not many of those favoring the direct taxation of small incomes would go so far and it is not likely that an all-inclusive income tax will be

tried at the present time.<sup>54</sup> However, a more moderate lowering of the exemptions to roughly 50 per cent of the present level would still leave the great majority of the voters free of any direct tax at all.<sup>55</sup> Improvement in the effective consciousness may be expected, but the ideal of universal consciousness is not to be expected.

However, insofar as fluctuation of individual incomes leads to change in the individuals who are included in taxable brackets, a fair estimate of the number of persons who are made tax conscious is not to be obtained from the number of taxable returns in a single year. If individual incomes could be expected to fluctuate in such manner that a considerable number of persons might be income taxpayers on the average of once every five years, the extent of tax consciousness would undoubtedly be increased. This group is to be thought of as being in addition to the group that will be income taxpayers in prosperous times and exempt when depression forces wage cuts and incomes of all types are reduced. How extensive this type of fluctuation may be is difficult to determine. Obvious examples of the writer or artist who may make enough to be included under the income tax only once every two or three years come to mind, but the number of persons in this class are very few. Another reason to believe that the existence of this sort of fluctuation of incomes is of some significance is the fact that it is now known that the cycles of all industries do not always move together. Perhaps the workers in the building trades will be paying income tax in one period and the farmers in another. However, it is probably true that the make-up of any income class is fairly well set.

Although it has been suggested that the income tax may be

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<sup>54</sup> The tax now used to finance old-age security carries no exemption but is not comparable to the general income tax for reasons given above. If the social security law is modified to include the self-employed and others now exempt, it is possible that an income tax of the more orthodox type will be suggested as a means of financing the additional burden. It would be unlikely, however, that the present tax deducted from the wages of employees by employers would be modified.

<sup>55</sup> The total number of taxable returns might be expected to increase to about eight or nine million under present conditions. (See *Facing the Tax Problem*, *op cit.*, p. 357.)

modified to develop somewhat more tax consciousness than it does today, nothing has been said about the question of maintaining the proper degree of tax consciousness with respect to the different governmental structures in the United States. Can the income tax be used to further the recognition of the connection between the expenditures of local governments and the total local tax bill? Can both the states and the federal government lower their exemptions at the same time? These are some of the questions that must be answered before the usefulness of the lower bracket tax can be estimated.

The income tax has never been used by the local political units and, in spite of the efforts of the Philadelphia City Council, it is not likely that it will in many cases. This is true because of the difficulty and inefficiency involved in the administration of an income tax in a small area. Unless it were used universally, which is not to be expected at this time, evasion and avoidance would be relatively easy. If administered locally, the costs would be raised by the necessity of duplicate organizations. On the other hand, if it were to be administered by the state for the benefit of the localities, the connection between local taxation and expenditures would be obscured. This is now the case in some states where the state administers an income tax and agrees to give the locality a certain percentage of the total receipts. The average taxpayer is not usually in a position to distinguish between the part of his tax due to state expenses and the part due to local expenses. It may be concluded that generation of local tax consciousness cannot be considered a possible function of the income tax.

Long experience in the imposition of the personal income tax in Wisconsin, New York, and other states, and the recent adoption of the income tax by many other states, has proved that the income tax can be successfully administered by the state governments. It follows, therefore, that those states without this tax could increase tax consciousness by obtaining at least a part of the state revenue from this source. The most important question is, however, the amount of tax consciousness that may be developed. Unless the states lower their exemptions below their present level, there remains a large part of the population



who will pay no tax directly to the state.<sup>56</sup> It is also true that the amount of tax consciousness that will be developed is greater as the amount of the tax paid in each case rises. This becomes an important issue as the majority of the states now have taxes that begin with a one per cent rate on the first \$1,000 of taxable income.<sup>57</sup> The actual tax payment that is made with this low rate will be so small in many instances that it is doubtful if it will be a very effective measure. For example, the tax paid on a taxable income of \$100 will be only \$1. It is doubtful if this is a large enough payment to promote real thought about the tax system with exemptions at their present levels.

Although it has been proved that the states can successfully administer the personal income tax, there is the possibility that before long there will be a movement to have the federal government administer the state taxes for the benefit of the states. This practice is followed in Australia where the Commonwealth collects the tax for one of the state governments.<sup>58</sup> Although this method of administration has many advantages, it would probably result in the reduction of the consciousness of state taxation and the confusion of the state with the federal tax burden unless the Australian practice of joint returns and separate payments to the federal and state treasuries were followed.

In the case of the federal government the lower the exemptions and the higher the rates, the greater the amount of tax consciousness that will be created. The direct connection between the federal tax and federal expenditures is maintained at the present time. Amalgamation of the state and federal tax administrations, as suggested above, might lead to confusion in the voters' minds, but if payment is separate this need not follow. It is sometimes held that the federal government has raised its income tax rates to a level that prohibits the use of this tax by the states. Although this may be true with respect to the imposition of state rate-scales comparable to the federal in progressivity, there is in the experience of New York ample

<sup>56</sup> See page 182.

<sup>57</sup> *Tax Systems of the World*, *op. cit.*, pp. 137-138.

<sup>58</sup> Haig, R. M., "Amalgamated Federal-State Tax Administration in Australia," *Proceedings of the Thirtieth Annual Conference on Taxation*, The National Tax Association, Columbia, S C., 1938, pp. 371-374, 380.

evidence of the effective use of any income tax with rates less progressive in the higher brackets. It is true, however, that separate administration of income taxes with exemptions at half their present levels might prove so costly that neither government would find it practical. Consideration of this problem and the alternative of a single administration is found below <sup>59</sup>

### Effects of Tax Consciousness

Up to this point no assumption as to the desirability of the creation of tax consciousness has been made. It has been assumed by many writers that the development of a tax system with a greater emphasis on the creation of tax consciousness would result in significant change in the attitude of the taxpayer with respect to government. However, they have not attempted to determine the possible limits to the effectiveness of this assumed reaction or the effects other than those expected by the advocates of the increase in tax consciousness. Investigation along these lines is necessary before the importance of the tax consciousness argument for lower exemptions may be determined.

The case for the direct taxation of small incomes to promote tax consciousness may be condensed into the following statement. Direct taxation of small incomes is the best way of promoting tax consciousness; tax consciousness leads to thought about the government that collects and spends the money; it therefore follows that the taxpayer will support government reform and reduction in expenditures. In the majority of cases there is also implied the assumption that anything that will limit the growth of government expenditures or reduce them is to be desired.

With the first part of the case for the taxation of small incomes, that which holds that this is one of the best ways of promoting tax consciousness, there can be little disagreement. Although there may be limits to the extent to which this tax may be used by the different governmental units, it is the ideal tax from most points of view. Non-shiftable, paid directly to

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<sup>59</sup> See page 151.

the government, and usually paid not too frequently to minimize the significance of the total burden, other things being equal, there is probably no other tax that is as well fitted to do the job.

Does it follow, however, that this tax consciousness will result in the promotion of desirable government reform or economy? There is evidence that this does not necessarily follow as a matter of course. Professor Lutz has summarized many of the weaknesses of the position that tax consciousness is a short-cut to good government and economy in the following statement. It is so pointed that it seems worth quoting in full.

One further word—about tax-consciousness. An immense amount of bunk has been written and said about that subject, and I confess that I in earlier years have been guilty as a contributor. The argument is, of course, that when people become tax-conscious they immediately go down to the city hall or to the state capitol and demand clean, honest, efficient government. That is only a pious hope, very largely unsupported by experience. That is not what happens when people become tax-conscious, except by accident.

Any kind of tax will produce a reaction, of course. But what direction will it take? You can no more predict it than you can predict the direction of the explosive force of dynamite. In New Jersey we had a sales tax, and it made the people very tax-conscious. Did they go to Trenton? No, except to demand the repeal of the tax. That was the direction the explosive force took in New Jersey, and they got away with it. They did promptly compel the repeal of the tax. They didn't compel better or cheaper government, not at all.

The eighteenth century Englishman was tax-conscious of the excise, and that was an indirect tax. Did he demand from each of the three Georges in turn that they give him better government? Not at all. He took it in clubbing and knifing the excise tax collectors when he got them in a dark alley. He took it out in smuggling and in extraordinary satisfaction from the consumption of smuggled liquor and tobacco because of the way in which he had put it over on the hated excise man.

If we want tax-consciousness—and I will agree that there is a proper place for that term—I think it is futile to count on getting it in any large degree through the ordinary operation of the tax system. The way to get it is to go out and organize yourselves in the form of taxpayers' associations or civic leagues or some other

civic groups and then feed your members enough hot stuff on what is going on in the city hall or state capitol or county government or some place else to get them really lined up behind the proposition that you want to put across.<sup>60</sup>

The Tax Policy League recently issued a statement in favor of the development of greater tax consciousness by the use of the direct personal income tax. However, in spite of the fact that they believe in the desirability of the development of more tax consciousness they are not unaware of the limitations of their case. The statement is as follows:

Tax consciousness will not result in a reduction of governmental expenditures if the masses of the people want those expenditures. Nor will tax consciousness result in constructive economies and governmental reforms unless the electorate is highly intelligent and informed concerning the desirability of such changes. The property tax did result in an unusual amount of tax consciousness on the part of property owners during the depression years . . . not constructive reform but enactment of socially undesirable measures resulted as propaganda groups used this consciousness—the small property owner not realizing new sales taxes would burden them more than lower property taxes.

Direct taxes can scarcely fail to result in tax consciousness. Whether such consciousness will induce taxpayer pressure upon the government will depend on the attitude of the taxpayer toward government expenditures. Whether any action so induced will be socially desirable or undesirable will depend on the state of enlightenment of the taxpayer group. Tax consciousness or tax responsibility as the writer would prefer to call it, is a desirable goal, and in an intelligent democracy should bring about an improvement in public affairs, but it cannot be regarded as a panacea for all government ills.<sup>61</sup>

This statement seems to be of particular importance as it brings out clearly the danger in the indiscriminate creation of tax consciousness. The use of tax consciousness by special groups to further their own interests seems, to the writer, to

<sup>60</sup> Lutz, Harley L., in a discussion reported in *Proceedings of the Thirtieth Annual Conference on Taxation*, The National Tax Association, Columbia, S. C., 1938, p. 161.

<sup>61</sup> *Tax Policy*, Vol. IV, No. 6, April 1937, p. 2

be almost impossible to prevent and, as is the case with most legislation for the benefit of special groups, the result is seldom to the advantage of the community at large. Some of the results of tax consciousness used by special groups that are of doubtful value to the community are constitutional property tax rate limits, homestead exemptions to help, or so it is claimed, the little fellow, and in general unwise curtailment of public expenditures for such services as the public schools, hospitals, and the like.

The reaction against undue optimism expressed by T. S. Adams should be remembered in this connection. He stated, not so many years ago but at a time when the nature of the tax conflict was less acute than it is at the present time, that "modern taxation or tax-making in its most characteristic aspect is a group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens." <sup>62</sup> The case for the creation of tax consciousness is not nearly so clear when its use by special groups is a distinct possibility.

One interesting possibility that has not been included in any of the discussions of the issue that have come to the attention of the writer is that with an increase in general tax consciousness on the part of the lower income groups, there may well be a demand for an increase, rather than a decrease, in the total expenditure of governments. This might become very strong if it could be pointed out to the persons with smaller incomes that under a progressive tax system such as is in force today it would be possible, even with a general increase in taxes throughout the tax structure, to have the increased benefits from the new expenditures exceed the increased taxes.

Another possibility is that the result would be to remove the tax entirely from the lower classes as a consequence of their sudden realization that they had to pay such large sums to support what they had believed previously to be a benevolent government. This reaction would not necessarily be accompanied by a willingness to reduce expenditure. The only result would be then to increase the rates in the higher brackets. Vested

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<sup>62</sup> Adams, T. S., "Ideals and Idealism in Taxation," *op. cit.*, pp. 1-8.

interests in the receipt of special benefits are very strong politically, as a consideration of the history of farm legislation and the veterans' pension program will indicate. Although it may be shortsighted, it is believed that for the most part these or similar groups are able and willing to take the point of view that their best interests are promoted by the grant of as large subsidies as it is possible to get with the hope that the other fellow will pay the bill. A universal income tax could be made a very useful tool by some political spell-binder promising its repeal and the maintenance of all benefits. Although much depends on the general state of mind of the people and the extent to which they have a real understanding of the nature of government finance, there is no reason to believe that the general type of reaction outlined cannot take place.

The most important point to be made, however, is that made by Lutz. That is, that if reform or reduction in expenditure is desired, the way to get it is by the proper sort of education and propaganda. Good leadership and the general state of mind of the people are of a great deal more importance in the achievement or failure to achieve certain ends than any mechanical provision of the tax system. The Princeton Local Government Survey has recently been developing effective techniques for the presentation of the facts about the local government in the State of New Jersey. Their belief is that only with the careful presentation of the real issues and the equally careful presentation of the steps that may be taken to correct the existing order is there any chance of bringing about any considerable improvement in the functioning of a democracy.<sup>63</sup>

Another fundamental weakness of the idea that an increase in tax consciousness will prove to be an effective check on expenditures is the fact that the real force of increased expenditures is felt only a year or more after the increase in expenditure has been made. Although this is the case in the natural course of events, the development of programs that are to increase in size over time and the use of deficit financing may place an even

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<sup>63</sup> Ely, J. F., and Robbins, J. J., "Popularizing the Results of Government Research," *The Public Opinion Quarterly*, Vol. 2, No. 1, January 1938, pp. 7-23, *passim*.

wider gap between the time of the increase in the expenditure and the time when the taxes must be raised to a new high level. When there is a lag of this sort the reduction of expenditures is made very difficult by the fact that there are firmly entrenched beneficiaries of the program. The political commitment to maintain the program is also very strong as there are likely to be not only the direct beneficiaries to consider but the indirect beneficiaries who are holding down the various administrative jobs. The time to fight is before the program is started. This can be done with some appeal to the already high rate of taxes but the real problem in a democracy is to persuade the voters that the newly planned expenditure is unwise before it is passed.

In many of the references to the issue of the lower bracket income tax it is suggested that the inspiration for the stand taken was derived from the success with which the English have used the direct tax on small incomes. There, one is led to believe, is a Utopia where the tax-conscious citizen is thoughtful of any increase in the national budget and maintains an eagle eye over the government to prevent the corruption that is the general rule in this country. In the first place there should be some real understanding of the nature of the extent to which the English tax the small income directly. This is not so easy to determine as would appear at first glance, as the mere translation of the exemptions stated in pounds into dollars is not sufficient to take account of the other important variables in the attempt to make a valid comparison between the two countries.

To get the bare essentials is the first requirement. The basic exemptions under the British income tax are £100 or \$500 for a single man, £180 or \$900 for a married person, and £60 or \$300 for each child.<sup>64</sup> These are increased materially, however, when the income is wholly "earned," by an "earned" income allowance of one-fifth of such income, up to a maximum of a total allowance of £300. This allowance has the effect of providing effective exemption levels, in the case of earned incomes, of £125 or \$625 for the single man, and £225 or \$1,125 for the married man. The effective size of the exemption for children

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<sup>64</sup> The conventional valuation of £1 at \$5 is used.

is increased in the same manner. These exemptions are well below those that are in effect in the United States at the present time, being slightly more than half as large for the single man and less than half as large for the married person.

The result of these low exemptions is, of course, to increase the number of taxpayers in the lower income brackets.<sup>65</sup> It is, however, not as effective in the inclusion of the majority of the voters as might be expected. In the fiscal year 1935, when the exemption for married persons was £10 less than it is today, the total number of taxable returns was 3,500,000. This is approximately nine per cent of the total population, or 13 per cent of the parliamentary voters.<sup>66</sup> Although this is greatly in excess of the 1.5 per cent of the population and 4.4 per cent of the voters in the national election of 1936 that are subject to the federal income tax, it is still not large enough to assure the creation of real tax consciousness on the part of a very significant proportion of citizens in the lower income brackets. Should the exemption under the federal income tax be lowered to a comparable level, it may be estimated that approximately the same percentage of the population would be subject to the direct tax. Changes in business conditions and variation in the standard of living in the two countries will of course make the number of

<sup>65</sup> Although there is little question that the exemptions in England are significantly lower than in the United States, the translation of pounds into dollars does not tell the whole story. In his comparison of the British and American income tax laws Spaulding makes the following comment "It cannot be assumed that if the exemption limits are the same, the tax burdens will be similar. If the cost of living is twice as high in the United States as it is in Great Britain, then the United States must make the exemption limit twice as high in order to impose on its taxpayers, other things being equal, the same burden as that imposed in Great Britain. The same consideration will apply to the rates of the income tax and super-tax but with less weight as incomes are higher. Nor can standards of living be neglected. If the standard of living is higher in the United States than in Great Britain, other things being equal, then income taxes at the same rates in both countries will interfere more with the habits and comfort of taxpayers in the United States, and will impose a heavier burden (because more keenly felt) on them than on taxpayers in Great Britain. But on the other hand, if the standard of living is higher, then real incomes will be larger, and income tax at a given rate will be less felt than in the country where standards of living are lower, and real incomes smaller." (Spaulding, H. B., *The Income Tax in Great Britain and the United States*, London, 1927, pp. 33-34.)

<sup>66</sup> There were 27,394,920 in the electorate in England and Wales in 1935. (*The Statesman's Year Book*, edited by M. Epstein, London, 1938, p. 6.)



persons who pay income tax with the same level of exemption differ as a percentage of the total population from time to time.

Although it is useful for the purposes of comparison to use the figure of percentage of total population as the percentage of actual voters, the more important figure is the percentage of the potential voting population that is subject to the tax. In the United States there are approximately 73,000,000 persons who are 21 years of age or over.<sup>67</sup> Assuming that a lowering of the personal exemptions would increase the total number of taxable returns to 9,000,000,<sup>68</sup> which would be the figure that would seem to be most likely if the British level of exemptions were adopted, only 12 per cent of the potential voters would be subject to the income tax, and the great majority would be paying small sums if the present system of rates and progression were maintained. It may be concluded, therefore, that although the British rates do result in the inclusion of a significantly larger number of taxpayers under the income tax, this level of exemption is not sufficiently low to result in the creation of even a bare majority of the voters with a direct responsibility to the government in the form of a yearly income tax.

Some of the critical comments on the British tax on small incomes should be included at this point. The minority of the Colwyn Committee on Taxation was of an entirely different view than the majority whose opinion has already been quoted. This minority believed that:

In the first place, it appears to us difficult to press the principle of "no representation without taxation" so long as the converse principle of "no taxation without representation" is not observed, as is the case today with considerable numbers of women taxpayers. Secondly, the whole argument seems to us to be of a somewhat academic character. We suggest only that those citizens should be exempt from taxation whose means are inadequate to support a reasonable standard of life.<sup>69</sup>

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<sup>67</sup> *Statistical Abstract of the United States, 1938*, Table 27, p. 34 gives the total 72,943,624 for the year 1930.

<sup>68</sup> See *Facing the Tax Problem, op. cit.*, p. 357.

<sup>69</sup> Committee on National Debt and Taxation, *op. cit.*, *Minority Report*, No. 79, p. 347.

Similar views were expressed at an earlier date by Carter and Houghton on the occasion of the lowering of the exemption limit during the war. Their criticism of this measure is still pointed enough to be worth considering at the present time. They wrote in 1918 after the novelty of the new exemptions had had sufficient time to wear off, in the following vein :

The Finance (No 2) Act of 1915 lowered the limit of taxable income from £160 to £130. The Act was passed without serious opposition, although it is estimated that the measure has affected some two million persons who had previously been exempt. This Act, like the National Registration Act and others passed during the war period, provides another example of the great difference between what people think the Government is doing and what the Government knows it is doing, and *vice versa*. It was argued that the new taxpayers would feel a deeper "sense of responsibility," that the payment of direct taxes would "stimulate an interest in Government affairs," etc. The actual effect has been narrowed down to a particular interest in getting the burden removed from the shoulders of the wage-earners at the earliest possible moment. This attitude might have been expected, as there are many precedents for wishing to remove the burden of taxation. But there are probably few cases, within the last fifty years, of new taxation where the feeling of injustice is more intense.

In the Report of the Commission of Inquiry into Industrial Unrest (in Scotland) the following appears (par. 18) "The bringing of workmen, earning what they regard as a bare living wage, within the range of the income tax, is strongly represented as a cause of unrest . . .", and, in the same paragraph "This is a matter which affects all classes of the community, and to make recommendations upon it is scarcely within the scope of this Commission. At the same time, we feel bound to report that the great mass of working men having been, for the first time, brought under the income tax is undoubtedly amongst the causes of industrial unrest."<sup>70</sup>

Similar evidence was presented before the Royal Commission on Taxation in 1919-20. Mr. Robert Shirkie, representing the

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<sup>70</sup> Carter, G. R., and Houghton, H. W., "The Income Tax on Wages by Quarterly Assessment," *The Economic Journal*, Vol. XXVIII, No. 109, March 1918, pp. 30-31.

Trades Unions Congress, made the following statement before the Commission:

Spending my life among the working people, and being one of them, I know that the present practice causes very many and serious hardships. In one district, so serious is the position that the County Court is flooded weekly with scores of actions for the recovery of small sums of Income Tax which, in many cases, the workers are unable to pay.<sup>71</sup>

Another type of reaction to the low exemption of the war period is cited by Hobson and one of the witnesses before the Commission. This is the restriction of labor output to prevent the half-yearly income from going over the tax limit. They claim that however foolish it may seem the miner or other worker is known to have taken a day off to prevent his income from reaching the taxable level.<sup>72</sup>

More recently the reaction to the severe cut in the size of the personal exemptions in 1931 brought forth the following comment from two British commentators. It is noteworthy as the prediction that the cut was too sharp and would be modified has been fulfilled.

A rather striking reversal of this process took place in September 1931, when it was presumably felt that members of the poorer classes ought to be asked to contribute their share to the public needs, and Mr. Snowden accordingly reduced the personal allowance to £100 for single persons and £150 for married persons. . . . Indirect taxation, however, is now the recognized method of levying unobtrusively a contribution to national expenditure from the masses of the wage earners, and, in view of the extension of indirect taxation now in progress through tariffs, it may be doubted whether it will long be possible to retain the new development of direct taxation downward as a permanent feature of the fiscal system.<sup>73</sup>

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<sup>71</sup> Evidence of Robert Shirkie, *Minutes of Evidence of the Royal Commission on the Income Tax*, 1919-20, #9139

<sup>72</sup> Hobson, J. A., *op cit*, pp. 46-47. Evidence of Mr Charles Edwards, representing the South Wales Miner's Federation, *Minutes of Evidence of the Royal Commission on the Income Tax*, #2343.

<sup>73</sup> Mallet, Sir Bernard, and George C. Oswald, *British Budgets* (Third Series, 1921-22 to 1932-33), London, 1933, pp. 486-487.

In all of the literature or references to the question of tax consciousness there is no concrete evidence presented to indicate that the effects of the tax consciousness induced by lower exemption have been favorable. There are many references to the desirability of the lower exemption but the support for this stand is always stated in the most abstract way and there is a marked lack of anything even resembling a positive proof that favorable changes have resulted from the broadening of the income tax base. In view of the fact that there is the evidence on the other side, it is no more than fair to say that the burden of proof still rests on those who are the advocates of the low exemption on the ground of the desirable effects of the resulting tax consciousness.

Recent interviews with the administrative officials of the Inland Revenue and with some of the local Inspectors of taxes in Great Britain revealed that they regard this argument for the low exemption of little practical significance. The only political significance that they attached to the low exemption was the general belief that the inclusion of the little fellow made it easier to place heavy burdens on the middle and upper brackets. This cannot be held to be a strong statement for the reduction of exemptions as a way of controlling expenditures. It may even be interpreted as a statement that the only way that an increase in expenditure may be financed is by the maintenance of the low exemption as a sop for those who really have to pay the bill.

Recent legislation with respect to the level of exemption in England is also of some interest. With the adverse effect of the world-wide depression in 1930 making itself felt in the finances of the country, exemptions were reduced to the lowest point in the history of the income tax in 1931. These basic exemptions of £100 for the single man, £150 for the married man, and £50 for one child and £40 for each additional child, were maintained until 1935. In that year the allowance for the married man was raised to £170 and the children's allowance was raised to £50 for all. In 1936 another raise was passed increasing the married allowance to £180 and the children's allowance to £60. Although there has been a constant increase in the revenue needs of the government as a result of the new rearmament program,

leading to the enactment in 1938 of a new high normal tax rate for all but the war years of 5s.6d., or 27½ per cent, these levels of exemption are still in force today.<sup>74</sup> It is also of interest to note that the recent increase in the normal tax rate has not affected the income tax paid by the little fellow. The old rates apply to the first £135 of taxable income. This is of particular importance as the maintenance of the same rate in face of increased expenditure is not the policy to be followed if it is believed to be desirable to bring about the maximum tax consciousness.

Another sign that the present government is not so anxious to develop tax consciousness is found in the fact that with the increase in the income tax rates in the middle and upper brackets there was passed a two pence a pound increase in the tea levy, an indirect tax that will affect all the poorer classes.<sup>75</sup>

### Conclusions

Although it has been concluded that approximately "two-thirds of the families in the United States are made tax conscious in the sense that they pay a substantial amount of money in taxes each year directly to some governmental unit,"<sup>76</sup> the tax consciousness of the members of any of the separate governmental structures in the United States is believed to be considerably less than that. Tax consciousness of local residents is believed to include about one-half of the families, state governments are believed to be less active in the promotion of tax consciousness,<sup>77</sup> and the federal government is the weakest of all.

The lowering of the level of the income tax exemptions may be used effectively by the states and the federal government to promote some additional tax consciousness, but the local governments will not find this a practical means of increasing the extent of the tax consciousness of the local voter. The practical limitations that are necessary to observe in the imposition of an income tax that is effective in the promotion of tax conscious-

<sup>74</sup> *New York Times*, April 27, 1938.

<sup>75</sup> *Ibid*

<sup>76</sup> *Facing the Tax Problem, op cit.*, p 360.

<sup>77</sup> Even though the automobile registration fee includes more than half of the families in the country. (See page 90.)

ness are, however, such that it is believed that even the federal or state governments cannot hope to use this tax as an immediate means of creating tax consciousness of the majority of their voters.

It must be granted, however, that it is possible that with the use of an income tax on the lower bracket incomes, the amount of tax consciousness can be increased in an amount that is of some significance. The results of the increase in the amount of tax consciousness are not, however, definite enough to provide a very strong basis for a plea that a great effort be made for the attainment of the tax-conscious citizen. Although the claims of the supporters of the program are impressive, the available evidence is not. As the problem is essentially one of predicting the reaction of the mass to a given type of tax program, no assertions either pro or con can be made with any degree of accuracy. However, it would seem that the burden of proof still rests on the believers in the usefulness of a serious attempt to increase the amount of tax consciousness in the country. This is true, as the experience in England tends to suggest that the practical effects are not at all what the average American believes them to be.

## CHAPTER 6

### ADMINISTRATIVE ASPECTS OF THE TAXATION OF SMALL INCOMES

The importance of the administrative practicability of a tax or a tax system is well recognized. If there is a choice to be made between the use of two taxes, not only must their respective effects on the distribution of the tax burden, on tax consciousness and their revenue potentialities be compared, but the difficulties of administration must also be considered. It may well be that a tax that is, in most respects, of definite superiority, will not prove to be as desirable in the end as a less refined measure if it is administratively impossible to assure uniformity of assessment and to prevent evasion on a wide scale.

Professor Seligman considered the question of administration of nearly as great importance as the question of justice. He believed that :

On all sides we are realizing the fact that the question of efficiency is scarcely, if at all, subordinate to the question of justice. Or, let us put it rather in this way: that however well justified, and however well calculated to promote the ends of justice a given scheme may be, unless its administrative features are so arranged as to make it workable, the beneficent aims are bound to be frustrated, and a half-way good measure which is administratively unobjectionable frequently turns out to be far superior to an ideal scheme which ultimately discloses serious faults in its administrative aspects.<sup>1</sup>

Although this problem of administration is of importance in all questions of taxation, it seems to be of particular importance in the problem that is the subject of this study. Evidence has been presented above that suggests that in the past the exemption of certain size incomes from the income tax has not always

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<sup>1</sup> Seligman, Edwin R. A., *Essays in Taxation*, *op. cit.*, p. 332.

been the result of the desire to attain an equitable tax system. In many cases it has been the result of the conviction that there was little chance to impose a workable income tax on the very small income. It has also been suggested that the degree of refinement of the existing income taxes is conditioned, in part, by the question of the administrative practicability of the suggested refinement. The development of the income tax to the point that it is today has been the result of the improvement in the technique of administration as much as any other factor.

The chief advantage of the personal income tax as it is known today is that it is a personal tax. As a result of the fact that it is a person who is the basis of taxation, full allowance can be made for differences in ability and assurance of the desired distribution of the burden with equity between individuals can be had. It is well recognized that it cannot boast of the advantage of simplicity Professor Seligman suggests,

But precisely because the income tax is a personal tax rather than an impersonal tax or a tax on things, it involves administrative difficulties and presupposes an advanced stage of social morality and political probity.<sup>2</sup>

Lord Stamp has made the same point very clear. He states,

It may not be out of place at this point to register a deliberate opinion that the clamour for a *simple* Income Tax, which he who runs may read, is an absurd one. In many particulars, not always the most important, the existing chaos of rules can indeed be greatly simplified, but if the tax is to be so highly subjective as to reflect every slight difference in ability, on the grounds of aggregate amount of income, marital condition, family responsibility, character of income, elements of capital, origin and source of profits, and all the other differentiae which are now urged, then, unless it is to be reduced to the status of a voluntary offering, it must be a complicated system.<sup>3</sup>

The recognition of the fact that the income tax is a refined measure of ability and cannot claim advantages over other taxes

<sup>2</sup> *Ibid.*, p. 15.

<sup>3</sup> Statement of Dr J. C. Stamp, *Minutes of Evidence of the Royal Commission on the Income Tax*, 1919-20, Cmd. 288, ¶9581.



on administrative grounds is essential at the start. It suggests that, contrary to the practice in the previous chapters, there is no point here in comparing the lower bracket income tax with the other types of tax to determine the relative superiority of the one over the other. It is conceded at the start that the income tax is more difficult to administer than many of the other taxes that are now being used to collect revenue from persons in the lower brackets. The question that must be considered, however, is whether or not the direct tax on small incomes can be administered at all. It is also important to estimate the degree of refinement that is compatible with administrative efficiency. It is possible to make full allowance for individual differences? What are the practical limitations to the attainment of true equality and progression in the distribution of the tax burden? What are the additional costs of the substitution of the income tax for already existing taxes? These are a few of the questions that will have to be considered if the complete picture of the direct taxation of small incomes is to be presented in a form that will permit something other than an arbitrary evaluation of its desirability.

It might be thought that, as the income tax is being successfully administered at the present time and as it is possible to make the actual tax conform in large measure to the ideal, the main question to be considered by the student of the lower bracket income tax is that of the cost of the administration of the tax in the lower brackets. This is not the case, however. Special problems arise as the exemption limit is lowered that are either non-existent with high exemptions or are of minor importance. The cost of collection expressed as a percentage of the revenue obtained is certainly to be considered, but there are other factors that are of equal importance in the determination of the administrative practicability of the lower bracket income tax at the present time.

Barring the possibility of trying the tax under different conditions, there is no way to determine with any great degree of certainty all of the special problems that may arise and the relative merits of the possible alternative ways of meeting these problems. However, it is found that by reference to the exist-

ing income tax and, particularly, to the experience in England, many of the points that may be expected to create special difficulties may be anticipated, and the weighing of the different possibilities of administrative technique may be undertaken with profit. It is proposed to make a general survey of this type before the specific problem of the administration of the tax under the present conditions in the United States is considered as a whole.

### General Problems

**Equity vs. Administrative Practicability.**—The chief case for the use of the lower bracket income tax is that it is the most equitable tax that can be used to obtain revenue for general purposes. It is not claimed, however, that it is the perfect tax. Under the administration of the existing income tax there are many compromises made as the ideal is not administratively practical. The question that must be faced at this point is the extent to which it is necessary to make additional compromises when the exemptions are lowered and the extent to which the preservation of the advantages of the personal tax in the lower income classes would necessitate additional administrative complications.

The demands of the equitable tax as set forth in Chapter 4 stressed in particular the necessity of the full allowance for the differences in the capacities of persons in different circumstances but with equal incomes. Specifically this required that allowance be made for the size of the family and also for expenses due to special circumstance that did not fall equally on persons with equal incomes. Items of this type were believed to be necessary expenses of a trade, and differences in the way in which the income was obtained, whether earned or received from investments. It was also suggested that medical expenses might be included in the future. There was also the problem of assuring the equal treatment of persons with equal real incomes and equal responsibilities.

With respect to the allowance for family circumstance there is no reason why the problem should assume any more impor-

tance than it does in the existing income tax administration.<sup>4</sup> The marital condition of the taxpayer is relatively easy to determine and the number of dependents is as easily determined as in the upper brackets. There might be a demand for some extra allowance made for the children over age who were receiving advanced education and living at home, but this would be merely a change in policy rather than a fundamental change in the administrative difficulty of the tax.

The question of the allowance for the medical expense of families is included, not because it is a common practice at the present time, as only one American state permits deductions of this nature,<sup>5</sup> but because it is believed that if the exemptions were to be lowered to any great degree there would be a very good chance that this allowance would be forced on the tax administrator whether he liked it or not. If this or similar allowances were to be granted, it would result in additional administrative work and expense. The difficulty of checking returns for this item would be considerable as there is no necessity of making a public record of medical services received, as there is of marriage or the birth of children. The possibility of extensive evasion would undoubtedly require that a more careful check be kept than for other items where the right to the deduction may be proved with greater ease. Various administrative techniques might be used to prevent this from becoming a burdensome feature of the income tax administration, such as the setting of an arbitrary limit to the total allowance that could be claimed. This would be, however, at the expense of equity.

Refusal to make allowance for the deduction of medical expense is, of course, another alternative. The percentage of the income involved in the lower brackets is, on the whole, larger than in the high and the resulting inequity of failure to make the proper allowance is therefore believed to be greater. It is not, however, a point that could be used against the adoption of the lower bracket income tax even if it were to be decided that the allowance were to be neglected. The present taxes on the small income make no allowance of any but the most negli-

<sup>4</sup> This would not hold if there is collection at source. See page 142.

<sup>5</sup> Minnesota.

gible sort for an expense of this type. Any relief that is obtained at this time is the result of the exemption from certain sales taxes of necessities and the failure of the excises to be placed on medical supplies. It may be concluded, therefore, that if this allowance is to be claimed as an advantage of the personal income tax in the lower income classes, it must also be acknowledged that the net result will be greater equity at the expense of an indefinite amount of additional administrative difficulty.

The allowance now granted by the federal government to those who have "earned" income could be carried down to the lower brackets with no additional difficulty, as it is assumed that all incomes under \$3,000 are "earned" under the present law. As the number that are not are relatively few, particularly in the lower brackets, no advantage would be gained by changing the existing practice.

The allowance for the expenses necessary to the acquisition of income is a fundamental part of the personal income tax. The allowance of this type, however, is believed to raise some special problems in the taxation of personal incomes in the lower income classes. With the present high exemptions, the claims are usually for business expense and may be supported by reference to records kept by the taxpayer. In the lower income brackets the claims of this type are almost certain to be made by the wage earner for the special tools and clothing that he needs in his particular trade or occupation. He is not apt to have any records or to be able to give a very accurate account of the exact amount that he has the right to claim as a deduction from the income tax. In proportion to the total number of taxpayers, it is likely also that in the lower brackets the number of claims to be settled will be greater than in the upper brackets where the salaried worker and executive may in many cases have no claims at all. If the administration seeks perfection, disputes as to the amount of claims are likely to plague it, as are the decisions about the items that are to be included and excluded. This would involve a great deal of expense of effort and it is extremely doubtful if the equal treatment of persons with similar claims could even then be achieved.

In spite of the difficulties that this type of allowance raises,

a solution is possible and equity and administrative practicability can both be had at the same time. The practical solution seems to be in the setting of definite allowances to all men in each trade in which the nature of the work involved indicates the need for special allowance. Although there would be inequities in any given year, the granting of regular allowances would tend to even off the ups and downs of the expense over a fairly short period of time.

In England this type of allowance has met with remarkable success. There is apparently little complaint since the trade allowance has been made, whereas before there was considerable objection on the grounds that the allowances that were settled in conference between the taxpayer and the local inspector were arbitrary and involved a considerable waste of time. At the time when the flat allowances were started, the following comment was made :

These flat-rate allowances have proved most satisfactory to all concerned. They are, however, exceptional, the procedure usually being for men to produce worn-out or spoiled clothes to the Surveyor and agree upon the cost of replacement. This method cannot but be the cause of great dissatisfaction and unequal treatment. It is also cumbersome and wasteful of time.<sup>6</sup>

One important feature of the English system is the fact that it settles the allowance to be made in each trade with the union representing the workers in this trade. The result is that, instead of having to deal with the individual workmen, there are trade union representatives who will meet with the representative of the Inland Revenue and agree as to the fair amount for each trade. In consulting with the Inland Revenue Principal Inspector in charge of this work, the writer was informed that there was seldom a dispute of any consequence on the grants that were allowed to the members of each union. He stated that the representatives of the unions were reasonable and that although the sums involved were relatively large in many cases, it was always possible to arrive at a reasonable compromise.

The lack in this country of well-organized trade unions with

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<sup>6</sup> Carter, G. R., and Houghton, H. W., *op. cit.*, pp. 30-42.

anything like the coverage they have in Great Britain would prevent the use of the most effective system of the British in the decision of the exact amount of the allowance in each broad classification. However, as the great advantage of this system is the fact that it tends to promote good feeling on the part of the workers because of their assurance of a fair allowance, there is no reason why the careful granting of the allowances by the government cannot be equally effective if the amounts are of a size that is in reasonable accord with the true expense involved. Failure to make reasonable flat rate allowances in any trade would undoubtedly cause much unnecessary irritation of the taxpayer and would tend to make the administration of the whole income tax more difficult.

Although it may be concluded that the question of allowance for expenses necessary to the acquisition of income presents a formidable administrative problem, there is no reason why there cannot be a compromise along the lines suggested above and the major difficulties avoided.

In the lowering of exemptions it was suggested that the limit be set at a level that was in conformity with the prevailing cost of some decent standard of living. Even if this is not consciously done, the lowering of the exemptions by any considerable amount would result in the income tax impinging on the subsistence level. In either event there arises as a result a new administrative problem. This is the necessity of making adjustment for the changes in the cost of living and perhaps, in the long run, for changes in the standard of living of the country in question. Although there is always the hope that the cost of living will not fluctuate to any marked degree, this is a hope that is not to be relied upon in as uncertain times as these.

The necessity for the exemption of a minimum income is a debatable issue, but if this is decided to be a wise course to follow it is then necessary to make an adjustment for any considerable change in the cost of living that may make the dollar allowance either too high or too low in terms of goods and services. Under the present policy of exempting all of certain classes of income well above the minimum, anything but a rather severe rise in the cost of living will not bring within the scope

of the income tax those who are not in receipt of the bare essentials of decent living. On the other hand, should the limit be set near the subsistence level, a slight rise would result in the inclusion of a large number of persons with less than was believed to be the amount necessary to provide for the minimum living standard and would probably result in a protest against the income tax that would become a serious matter to those who were in charge of the administration. If the price level should move in the other direction and the cost of living go down, the resulting failure to maintain the coverage that was contemplated when the limit was set would not necessarily be of such consequence but would result, of course, in the tax being less inclusive than had been the wish of the authorities who developed the program.

The administrative effects of the adjustment for the changes in the cost of living must be considered. There is, in the first place, the problem of measuring the change in the cost of living for the country as a whole and possibly making allowance for variations from one part of the country to another. This would not be difficult at the present time as there is already set up the index of the Bureau of Labor Statistics that measures the change the cost of living of the lower income groups. The real problem is the effect of frequent change upon the ease with which the tax may be collected.

In dealing with the large numbers of taxpayers that low exemptions would make taxable, the failure to maintain a fixed level of exemption has many disadvantages. If the present practice of self-assessment was continued, there would be a problem of keeping the taxpayer informed of the changes that were made from time to time. How difficult a problem this would be cannot be determined but the burden on the government would be greater than it is when it can rely on general knowledge of the exemptions that are continued over a period of several years. The employer would also be subject to additional burdens if the present use of information at the source were to be continued or if collection at source were used. He is able at the present time to set up his records for the reporting of persons with wages or salaries above the exemption limit

with the expectation that these levels will remain in force over a considerable period of time. If there were changes in the level of the exemptions there would be the necessity of making a check of his wage records to be sure that he was reporting the proper employees under the new level. However, the additional burden is reduced by the fact that the employer has to report all wages paid for the old-age tax.

The tendency for wages to lag behind price movements would also be of concern to the administration that believed it necessary to grant that there should be changes in the exemption level with changes in the cost of living. This would create special difficulties as there would probably be an increase in the number of taxpayers who were included under the income tax for only a year or two but not regularly enough to permit either the government or the taxpayer to become adjusted to the settlement of the claim. For example, if the cost of living should fall and the exemption were to be lowered to make adjustment for this fact, there would be many workers who had not had their wages cut who might be included within the scope of the tax for the year and by the next year receive their cut and once more fall below the exemption limit. In the event of a rise in the cost of living there would of course be the opposite effect if the wage earner failed to get his increase in wages as soon as the change was made in the size of the exemption. Under these circumstances there would be a reduction in the number of persons included under the tax, and consequently a reduction in the administrative burden. However, regardless of the direction of the change in the cost of living, there would be a tendency for the number of infrequent taxpayers to be increased, resulting in the increase in the difficulty of the administration of the tax in the lower brackets.

Another difficulty with the necessity of frequent change in the level of the exemptions is that it is to be expected that the taxpayer would not fully understand the reason for the change. Although there would be little difficulty if the exemption was to be raised, the lowering of the level would probably result in protest on the part of the taxpayers whose money income had not changed and who found themselves paying an income tax



for the first time. The concept of a "real wage" is difficult to understand and the use of an index based on what is believed to be a representative sample of the goods that the worker is buying is always bound to be unfair to some individuals or groups in the population.<sup>7</sup>

Here is a clear case where the desire to increase the equity of the tax system will lead to an increase in administrative difficulty. Compromise is probably necessary in the decision of the frequency with which the adjustment is made. One possible way to prevent too frequent change in the exemption level would be to modify the exemptions only when the change in the cost of living amounted to more than a certain percentage, let us say 5 or 10 per cent. The effect of a change in the price level on the income tax is, however, of such importance that careful consideration should be given to proposals which would prevent haphazard changes in the incidence of the true burden.

The determination of net taxable income of persons in the lower brackets raises several additional problems. Equity requires that there be equal treatment of all persons with equal incomes and equal responsibilities. What are the administrative limitations or special difficulties arising at this point?

To assure equality, money income received during a fiscal period cannot be the sole measure of taxable capacity. The farmer receiving an income of \$500 in cash may be as well off as the factory worker who receives an income of \$1,000 if the farmer is able to produce farm stuffs worth \$500 for his own use. If there is to be equal treatment of the farmer and the factory worker, this income in kind that the farmer enjoys should be included in his taxable income. To determine the value of this type of income is, however, most difficult. At the present time no attempt is made in this country to tax most of this income not realized in cash, but the issue is not of as great importance with the present level of exemptions as it would be if the exemptions were to be lowered by any considerable

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<sup>7</sup> The experience after the World War, when there were many wage adjustments on the basis of changes in the price level, indicated that the workers generally protested the lowering of wages in proportion to the fall in prices after 1920. (See Douglas, Dorothy W., "Cost of Living," *Encyclopedia of the Social Sciences*, Vol IV, New York, 1931, pp. 478-483.)

amount. This is true as there are few farmers, factory workers, domestic workers, or farm laborers who receive a large part of the non-cash income who are subject to income tax with the present high exemptions.

Although the problem of the income which is realized in some other form than cash raises special difficulties, the determination of even the cash income would be more difficult in the lower brackets than with the higher exemption now in use. The farmer, the construction worker, or the migratory worker is likely to keep very poor records of the total cash income over a period as long as a year. Even granting that the intentions of this type of worker were of the best, to present him with an income tax blank and tell him to record the total income for the year would not be likely to produce very consistent results.<sup>8</sup> For all of the poorer paid workers but those regularly engaged in the large industrial plant where the records of the employer

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<sup>8</sup> In Kansas, where the exemptions are lower than the average (\$750, \$1,500, and \$200), and the percentage of the population engaged in agriculture relatively high, this problem has apparently become acute. In a letter to the writer, written in May 1937, Ellis D. Bever, Director of the Income Tax Department of the State Tax Commission, made the following statement: "There has been little difficulty in enforcement of the Kansas law as applied to individuals who receive salaries, wages, commissions, or other forms of compensation, which are reported by the employers. It is almost impossible of administration as applied to small merchants, farmers, and other individuals who have kept no records in the past and whose income is so small as to make cost of collection almost prohibitive where the tax involved at the one per cent rate provided in the first bracket of the Kansas law would produce \$10.00, or less, for each year."

In South Carolina, a state with slightly higher exemptions (\$1,000, \$1,800, and \$200), W. R. Bradley, Director, Income Tax Division, South Carolina Tax Commission, wrote to the author in 1937 in the following vein. "The State has met with very little opposition from the adoption of the policy of low exemptions. The greatest difficulty has been experienced from apprising the taxpayers of their devoirs in this regard. The lower the exemptions go the less informed is the class taken in thereby."

In Wisconsin where single persons with \$800 and married with \$1,600 file returns, it is believed, "It is probable that there is some under-reporting of income. Income tax returns are made after the close . . . many of them 75 days after the close . . . of the income year, and without adequate book-keeping, the financial transactions of the preceding year are hard to reconstruct. This is more true in the case of farmers and small business men than in the case of wage earners. Nevertheless, the latter group, unless they have regular work on a salary basis, may conceivably have difficulty. Minor sources of income, received at irregular and infrequent intervals, may also escape reporting." [Wisconsin Tax Commission, *Wisconsin Individual Income Tax Statistics. 1936 Income*, Vol II, Mimeograph, no date (1939-?), pp 4-5]

are rather complete, there would be no way of checking the income reported. The lack of the possibility of any check at all would probably result in the development of a special problem of evasion that would end by having the effect of placing a relatively heavy burden on the honesty of the citizen who reported his income in full, and upon the worker in an establishment where the employer was able to make returns to the tax authorities of the wages paid<sup>9</sup> In the higher brackets, if all else fails there is always the possibility of checking the bank deposits of the person believed to be evading the income tax. As the percentage of the poorer classes that have anything more than a savings account is small, there is not even this possible check to be relied upon.

One way to avoid this particular problem seems to be the use of a system requiring the regular deduction of some amount toward the tax when the cash is paid to the worker. The problem of the farmer-owner and the small business man would still remain, but it might be solved by the requirement that they all keep accounts for the purpose of income tax regardless of past liability to the tax. This type of requirement might be of advantage and prove popular, as one need of many farmers is the maintenance of an adequate set of records that could be used to indicate profits or losses.

The practice of deduction at the source would prevent a large amount of evasion and lessen the difficulty of determining the true cash income for the year. However, there still would be

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<sup>9</sup> L. D. Shellworth, Director of the Department of Income Tax, State of Idaho, stresses this point in a letter to the author. "Experience has shown that particularly low personal exemptions tend to create more evasion although a large percentage of these evasions are caused by ignorance rather than intentional disregard of the Law, also a large percentage of individuals in the extremely low income class are apt to be unstable as to their place of employment and residence. This creates a serious problem in determining the amount of income received by the individuals, as well as his place of residence, which naturally increases the cost of collection from these individuals."

William H. Stauffer, Economist of the Department of Taxation of Virginia, is also concerned about this problem. He suggests in a letter to the author that "In the case of independent enterprisers such as professional men, farmers, and small merchants, there is undoubtedly more opportunity for evasion in the preparation of interrogatories than in instances where adequate records are kept and where the administrative authority can look to other sources for information as to the income received by the taxpayer."

administrative problems if full recognition were to be made for the individual differences in each case. The greatest of these is the problem that would arise in the refunding of tax paid in excess of the final liability as determined at the end of the period. Consideration of the use of collection at the source will be made more fully later.

Of the problems that arise in connection with the consideration of the administrative practicability of the assurance of an equitable income tax in the lower brackets, the most difficult is believed to be the problem of assuring the full taxation of all persons with equal real incomes. The allowance of the proper deductions for differences in responsibilities is relatively easy but the problem of the bringing to full account the farmer, domestic and farm servants, the worker in other than the well-organized plant with full wage records, and others of this type is a most serious one. As the percentage of the workers employed in the larger establishment has increased in the last twenty or thirty years, this would seem to make it easier to contemplate the lowering of the income tax exemptions than it was some time ago, but the number of workers in the occupations or positions that would create special difficulties are still large.

One special problem that arises with the inclusion of the wage earner and other more poorly paid workers under the income tax is the frequency with which they shall be required to discharge their tax liability. The greater the frequency of payment, other things being equal, the greater the administrative problem. There is also the problem of the lag that will be maintained between the time of the receipt of the income and the discharge of the liability.

Lord Stamp has given a great deal of thought to this question and has written in the following vein:

We are so used to considering income by the year that it seems to be almost an ordinance of nature. Yet vast numbers think only of their weekly wage, and could not readily say what their yearly income is. Those who think in terms of annual income plan their expenditures very much upon a yearly basis, without special regard to monthly fluctuations due to holidays, or the winter coal or light. Their ability to pay an annual tax can clearly be measured in the

same way. But the weekly wage-earner's outlook is much more limited—he may be relatively prosperous and relatively depressed within a short space of time, owing to an alternation of overtime with short time; his tenancy is weekly; he has relatively little power of “carrying over” His ability cannot be held in suspense. Often his only means of looking well ahead is that provided by coal clubs, holiday clubs, and the like. His “ability” to pay taxation must be measured by a shorter term. That is why some people who favor a graduated deduction from wages by a stamp system, instead of an income tax, regard the annual income as quite incongruous for the conditions to be met. By the time the money comes to be paid, the facts of the moment are quite out of accord with it, whereas deduction must always exactly fit the ability. The quarterly methods actually adopted in this country are some recognition of the principle involved.<sup>10</sup>

The extensive use of the instalment plan of selling goods of any considerable value in the United States and the practice of the insurance companies selling small policies to the wage earner with weekly or monthly collection of the premiums are evidences of the necessity of recognizing the need for frequent collection of the income tax, should it be broadened to include the same type of worker and were the rates at the bottom of the scale sufficiently high to require more than a nominal payment to discharge the tax liability. The lower the exemptions, the more pressing this problem will become.

Dalton also believes that this problem is one that will become troublesome should the exemptions be materially lowered. He writes,

An income tax on small incomes from wages must either be paid in one or two annual payments, which inflict great hardship on the taxpayer and are difficult to assess owing to weekly variation in wages, or in a larger number of instalments during the year, an arrangement which greatly increases the cost and trouble of collection, while not altogether avoiding the difficulty of wage variations.<sup>11</sup>

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<sup>10</sup> Stamp, J. C., *The Fundamental Principles of Taxation*, London, 1936, pp. 27–28.

<sup>11</sup> Dalton, Hugh, *op. cit.*, p. 156.

The way in which this problem is met in England and other possible means of administering the tax to avoid the difficulties noted above will be considered in the discussion below.

**Cost of Collection.**—The administrative cost of an income tax on small incomes is a fact that is of primary importance. Adam Smith was practical enough to realize that the just tax system should be, not only one that was equitable but one that was also so efficient that the cost of administration did not, in effect, impose a large additional tax. He objected to taxes that “may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose prerequisites may impose another additional tax upon the people.”<sup>12</sup>

The soundness of this principle is generally admitted. It is still true that the primary purpose of taxation is to collect revenue. If a disproportionately large part of the revenue collected is consumed in the process of collection, the tax may be severely criticized even though it is the most equitable tax in the system. It is even possible that the gain in equity would be cancelled by the fact that the high cost of administration required such a high tax rate to produce any net revenue that the rather dubious achievement of requiring all persons to pay at least as much as the group formerly discriminated against would be the limit of the gain. Although it is not possible to weigh precisely the advantage of greater equity against the disadvantage of increased cost, the cost factor must always be included when evaluating the tax system as a whole.

The importance of the cost of administration of a tax or a tax system suggests that there should be available data for the purpose of making comparisons of the different types of taxes or tax systems. This necessary material is, however, available in only the most fragmentary form. In this country the federal government makes available figures of the total cost of the administration of the department of internal revenue which is the administrative agency for the income tax, the excise taxes, the

<sup>12</sup> *The Wealth of Nations, op cit.*, Vol. II, Book V, Ch. II, Part II, p. 311.

estate tax, the social security taxes, and excess profits taxes. No assistance may be obtained from this source as to the relative cost of the administration of the different types of taxes. The state governments are slightly better in this respect but there is a real lack of the type of figures that would be useful in this problem. A recent study of the costs of administering state and local taxes resulted in the following conclusion:

It may be evident from these few examples—and they could be multiplied—that thruout the entire field of state taxation the available cost of collection data are very incomplete. In addition, they in general fall short of the degree of reliability required of data that are to be used as a basis for any significant conclusions.<sup>13</sup>

The limited number of available estimates of the cost of the administration of the personal income tax are stated in such a manner that it is practically impossible to obtain an estimate of the difference in this type of cost in the low brackets and in the high. Although it is sufficient for the ordinary uses of these data to know the percentage of revenue for a single tax, with the use of the progressive rates and the granting of the exemptions under the personal income tax there is need for some measure of the cost per return at different income levels. If it is found that percentage of the total revenue collected under an income tax that was required for the administration of the tax was 5 per cent, this does not reveal much about the cost of collecting the tax from the lowest income classes as compared with the highest.

In an effort to obtain some useful information, the writer communicated with the administrative officials of all of the states with personal exemptions below those in use by the federal government, asking them if they had any data on the relative cost of the collection of the part of the income tax obtained from the taxpayers at and slightly above the exemption limit. The response was notable for the lack of any definite replies. Although this was not unexpected, it would seem that there is a place for some intensive study of this particular problem in the

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<sup>13</sup> Reynolds, T. J., "Cost of Administering the Various State and Local Taxes," *Studies in Current Tax Problems*, pp. 107-140.

states that believe for one reason or another that it is worth while including the small man within the scope of the tax. It would require that an elaborate system of accounts be maintained to separate the costs for the one part of the tax from the others. The proper share of the overhead of the tax department would have to be allocated to the lower bracket income tax as would be the proper part of the time spent by officials whose duties included something other than the particular part of the income tax which is of concern to the study.

Another difficulty with the use of the usual cost-as-a-percentage-of-the-total-revenue figures is the fact that the rates in force, and the place where the line between the small and the large income is drawn, will make a real difference in the answer obtained. For example, if the cost per return is the same in two states, the cost-as-a-percentage-of-total-revenue will be high if the income tax rates are low, and relatively low if the rates are high.<sup>14</sup> In either case the cost will represent a larger percentage of the total revenue at the margins, where the tax collected is only a nominal amount.

From this fact it may be concluded that with the present distribution of the national income, unless the cost per return is lower in the low income classes than in the high, the cost-as-a-percentage-of-revenue will for the whole income tax be increased by the lowering of the exemption limit. This will be the result as the number of marginal returns with small tax liability will be greatly increased as the exemptions are lowered. The distribution of the national income is such that the lower the limit is set, the greater the increase in number of taxable returns, and therefore marginal returns, per \$100 reduction. Whereas the number of additional returns that would result from the reduction of the married exemption from \$2,500 to \$2,400 might be, let us say for purely illustrative purposes, 500,000, the reduction from \$2,400 to \$2,300 would be expected to result in the increase in the number of returns of possibly 1,000,000.

In spite of all these difficulties the idea of the cost of adminis-

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<sup>14</sup> It is possible that an unusually high rate on the lower brackets would result in extensive evasion and reduce revenues and increase costs. However, under normal conditions the generalization is believed to hold.



tration of the direct tax on small income has real meaning and is an important factor in determination of the desirability of this tax. Although there are only meager data available, they provide some useful information.

One of the most suggestive sources of information on the cost of the administration of the personal income tax in the lower brackets is to be found in the experience of the State of Utah which has recently tried different policies of dealing with these incomes. The state adopted the personal income tax in the year 1931 and obtained its first returns in the fiscal year 1932. One of the features of the new tax was the requirement that all persons except the "infirm, idiotic, insane or indigent" should file a return with a fee of one dollar in each case whether the income was taxable or not. The report of the state tax commission for the fiscal years 1933-34, after the tax had been in effect sufficiently long for the necessary administrative machinery to be set up and some conclusions as to the functioning of the tax in Utah to be reached, contains the opinion of the commission as to the practicability of this measure. It is believed to be worth quoting in full.

The enforcement of the requirement for practically every individual over the age of 21 years to file an income tax return and pay a filing fee of \$1.00 presents some serious administrative difficulties. Even under normal conditions when a generally favorable attitude on the part of the public might be expected the cost of preparing, mailing and checking would take a fairly large part of each dollar received. Under the conditions of the past two years the cost is materially increased because of resentment against this requirement by such a large proportion of those who are required to file returns and pay the filing fee. Thousands of people who are unemployed fail to file returns or to make any explanation. It is necessary for the Commission to list such persons as delinquents and to treat them as such. In these cases it sometimes happens that the Commission spends more than a dollar on an individual in looking him up and requiring him to file a return, only to find that he is indigent and therefore unable to pay anything. This process is a very expensive one and is one of the reasons for the high cost of administering the income tax act.

This brings up another administrative difficulty which is under-

mining the enforcement of the act and is increasing the difficulties each year. The law provides that the Commission may abate the filing fee in cases where, in the opinion of the Commission, such abatement is justified. Without a doubt there are many thousands of cases where an abatement of the filing fee has been proper and the Commission has abated the fee in every case where the facts which were presented to it justified. The difficulty arises from the fact that some people do make dishonest claims for remission and the Commission has not had sufficient funds to investigate each claim. As a result, a premium is placed upon dishonesty and enforcement of the act has become more difficult each year. Each year more people are learning that the Commission cannot make an adequate investigation of claims for remission.

It is our opinion that the provision for the universal filing of returns, together with the payment of \$1 00 with each return, should either be enforced adequately or it should be repealed. To enforce the act properly under the present circumstances would require a great deal more funds than have been appropriated to the Commission for this purpose, and unless the Legislature can provide adequate revenue for proper enforcement, we seriously recommend that the law be repealed.<sup>15</sup>

In a later passage the Commission makes the following additional statement with respect to the taxation of the small income :

If it is proposed to reduce the exemptions, care should be taken to prevent the reduction to an extent that the law will compel the filing of returns and the payment of taxes in such small amounts that the expense of handling and the difficulty of collections will be nearly as great as the expense at present with the provision of universal filing. We can say without hesitation that if the exemption to a single individual of but \$500 00 is permitted there will be thousands of returns filed upon which the tax cannot be collected.<sup>16</sup>

The cost of the administration of the income tax was extremely high at this time, amounting to 34 per cent of the total revenue from this source in the fiscal year 1933, and approximately 30 per cent in the fiscal year 1934. Unfortunately, there was in effect at the same time the provision that the property

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<sup>15</sup> *Second Biennial Report of the State Tax Commission of Utah for the Years 1933-34*, pp. 38-39.

<sup>16</sup> *Ibid.*

tax could be used as an offset against the income tax up to one-third of the income tax payable. This undoubtedly is a factor in the unusually high administrative costs expressed as a percentage of net revenue. However, the conclusions of the Commission are still impressive.

The difficulties experienced by the Utah Commission in administering a filing fee suggest that if a personal income tax with full allowance for the status of each individual were to be used under similar circumstances, the cost would become prohibitive and the problem of evasion one that would be insoluble. The extensiveness of evasion under the filing fee is not stated by the commission but the report quoted above indicates that it had become so common that there was danger of the whole income tax system breaking down. There is also the suggestion that had the commission tried to enforce the filing fee to insure the complete return of all persons required by law to pay the fee, the costs would have risen well above 30 per cent.

The Legislature in 1935 acted on the recommendations of the commission and repealed the filing fee and also the property tax offset. The first returns made under this new law, which also raised the rates of the income tax and lowered the exemptions, were for the fiscal year 1936. Immediate reduction in the cost of collection of the income tax was the result of this action. In contrast to the 30 per cent figure for the tax with the property tax offset and the filing fee, the figure for the year 1936 was 8 per cent.<sup>17</sup> Unfortunately for the purposes of this study, the Legislature did too much at one time. The significance of the new lower figure for the cost of administration of the income tax is lessened by the fact that there was the cost-reducing and revenue-increasing repeal of the property tax offset, the revenue-increasing rise in the rate schedule, the cost-increasing reduction in the level of the exemptions, as well as the repeal of the filing fee. Out of this mass of legislation there can be no very clear-cut information as to the exact effect of the repeal of the filing fee. It is believed, however, to be an important reason for the

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<sup>17</sup> *Third Biennial Report of the State Tax Commission of Utah for the Years 1935-36*, p. 184.

sharp reduction in the cost figure.<sup>18</sup> There are no data available as to the rigidity with which the Commission is enforcing the new lower exemptions which are at the point where the single man with an income of \$600 or more is liable to the personal income tax. The question is raised because this is dangerously close to the exemption of \$500 which the Commission said that it could not enforce.<sup>19</sup>

A similar measure was tried in Delaware and although the reports of the success of the administration are conflicting, it is interesting to note that it was repealed after a six-year trial period. From 1921 to 1927 the state income tax law required all residents 21 years of age or over, everyone under 21 receiving a net income of \$1,000 or over, and fiduciaries to pay an income tax filing fee of \$3.00. In 1923 the law was amended "to exempt persons from making a tax return of paying a tax upon presentation of evidence that they were wholly dependent upon the state or upon other individuals for support."<sup>20</sup>

Members of the income tax administration considered the trial of the filing fee a success and of material assistance in the

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<sup>18</sup> Inquiry from the Commission brought forth the following response:

"While probably the main reason for reduced administrative costs has been the elimination of universal filing and the filing fee, I feel that the basic changes in the provisions of the Act and improved efficiency of the Commission are also largely responsible" (Letter written to the author by V. H. Coombs, State Tax Commission, May 12, 1937.)

<sup>19</sup> W. M. Bates of the Collection Department of the State Tax Commission answered an inquiry on this point as follows: "Our experience in administering the collection provisions of the income tax law since the personal exemption for a single individual was reduced to \$600.00, indicates that the prediction of the Commission somewhat over-estimated the difficulties which would be encountered if the exemption to a single individual of but \$500.00 or more was permitted, due to the fact that we have had comparatively few cases of outright evasion and cases where the individual was unable to pay the tax which had accrued against him. It is just possible, however, that our difficulties in this respect would have been greatly increased if the exemption to a single individual had been \$100.00 less, for the reason that many of these individuals would be in the unemployed or part-time employment class. We found, under the old law which required the \$1.00 filing fee with each return, that quite a number of single individuals with incomes of \$500.00 were actually unable to pay the filing fee when the same became due and consequently found it necessary to ask for remission of this fee. This was also true of married persons with incomes of \$1000.00" (Letter written to the author on June 2, 1937.)

<sup>20</sup> National Industrial Conference Board, Inc., *State Income Taxes*, Vol. I, New York, 1930, pp. 52-53.

collection of the regular personal income tax.<sup>21</sup> They have also indicated that it was repealed as a result of political reaction and against the wishes of the administration. The State Tax Commissioner estimated the cost of collection of each \$3.00 fee at 10 cents and stated that the penalty imposed was more than enough to cover the cost of collection of delinquent returns.<sup>22</sup> He also estimated that the tax status of 87 per cent of the population 21 years of age or over had been accounted for by means of the filing fee requirement.<sup>23</sup>

In another study made at the time the filing fee was about to be repealed, the National Industrial Conference Board presented a much less favorable picture. They held that there had been many delinquencies and that the only means of enforcing collection was through the magistrates' courts which charged an average of \$2.20 "costs" to collect a \$3.00 fee. They also believed that an insufficient tax-collecting force had hindered collection.<sup>24</sup>

Although in the first years that the filing fee was imposed it was nearly as good a revenue producer as the personal income tax, in the last two years before its repeal the returns from the regular income tax increased at such a rate that the filing fee became relatively much less important.

The sudden increase in the yield of the personal income tax as indicated in Table IV is believed to be explained by the transfer of the administration of the tax from the State Treasurer to the School Tax Commissioner in 1925.<sup>25</sup> It is also of interest to note that the School Tax Commissioner found it necessary for the enforcement of the income tax law "to spend more money than was appropriated for that purpose, consequently he expended \$64,593.00 of his own funds."<sup>26</sup> Another reason for the great increase in the yield of the tax was the increase in the number of very large returns. In 1926 there were 26 returns

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<sup>21</sup> *Ibid.*, pp. 52-53.

<sup>22</sup> *Ibid.*, p. 52.

<sup>23</sup> *Ibid.*, p. 53.

<sup>24</sup> National Industrial Conference Board, Inc., *The Fiscal Problem in Delaware*, New York, 1927, p. 76.

<sup>25</sup> *Ibid.*, p. 55.

<sup>26</sup> Daugherty, M. M., *Studies in Taxation, Financing Education in Delaware*, Newark, Delaware, 1932, p. 44.

TABLE IV. YIELD OF THE FILING FEE AND THE NET INCOME TAX IN THE STATE OF DELAWARE FOR THE YEARS 1922-1929 \*

Year <sup>a</sup>	Net Filing Fee Collections <sup>b</sup>	Net Income Tax Collections <sup>b</sup>
1922	272,229.00	286,492 50
1923	234,399.00	381,411.04
1924	246,120.00	421,809.65
1925	280,560.00	583,158 75
1926	309,824 60	1,034,331 96
1927	306,637.07	1,377,207.06
1928	33,602.66	1,611,149.84
1929	17,706.68	2,272,375 43

\* Source. *Report Delaware State Tax Commissioner, 1929.*

<sup>a</sup> Year of collection—based on the liability of the previous year.

<sup>b</sup> The net figure represents total collections in the year due plus delinquent payments, less refunds

of \$250,000.00 and over, paying \$564,206.54 total tax. In 1928 there were 42 returns of \$250,000 00 and over, paying a total of \$1,032,831.34.<sup>27</sup>

Lack of more complete information and the rather unusual administrative set up in Delaware make an appraisal of the experience difficult. Although it is the opinion of the administration that the fee was useful in the collection of the income tax, it is possible that an expenditure of an equal amount on the administrative machinery would have been productive of the same amount of revenue with less inequity.

Although there is not the detailed information available and the laws are not comparable, the experience in West Virginia seems to support the conclusion reached after consideration of the Utah experiment. H. Isaiah Smith, Director of the Budget and formerly in charge of the administration of the income tax, writes as follows concerning the success of a gross income tax and later an income tax with low exemptions as used in that state:

The gross personal income tax provided for an annual exemption of \$600.00 for single persons, \$1300 00 for married persons and \$200.00 for each dependent. This, we found to be very unsatis-

<sup>27</sup> *Ibid.*, p. 33.

factory. The law was changed in 1935, and under provision of the Act the tax was to be collected on the basis of net income with a personal exemption of \$600 00 for single persons, \$1300 00 for married persons and \$200 00 for each dependent. I found that these two Acts, with reference to the lower income classes, were unsatisfactory in view of the fact that the amount of the tax collected on each return was small and hundreds of cases did not even provide a sufficient amount for administrative purposes.

In 1937 the law was changed again and the exemptions raised to \$1,000 for single persons, \$2,000 for married persons, and \$400 for each dependent, and a graduated rate applied to the net taxable income. Mr. Smith reports that the new law is fairly satisfactory although he believes that the net income tax is difficult for a state to administer and, if any substantial amount of revenue is to be realized, the rates must be necessarily fairly high.

Other comparisons of the practice of the different states are not of any real significance. Either the data are too fragmentary or the policy pursued by the state has been so consistent that there is no possibility of making a useful study of the changes that have taken place in recent years. The possibility of comparing the costs of collection of the personal income tax in the states with different levels of exemption was considered, but it was concluded that the results were apt to be misleading rather than helpful. This is the case because the conditions in the different state administrations and in the type of taxpayer in the state can vary to such a degree that isolation of the influence of the low exemption could not be hoped for.

The difficulty in arriving at an estimate of the true cost of collection of the direct tax on small incomes is not confined to this country. In England where the lower exemptions have made this point a more pressing issue than in this country, there have been numerous estimates of the cost, but the wide discrepancies between the figures arrived at by different groups leaves the issue as vague as before. Thus it is found that Lloyd George had estimated that in 1919 the cost of collection of the tax on "small shopkeepers and the men who do odd jobs of all kinds"

is as high as 70 per cent of the total revenue collected.<sup>28</sup> Another member of Parliament estimated that the cost of collection of the tax on the incomes just above the exemption limit was "at least more than half the amount collected."<sup>29</sup> At the same time the Board of Inland Revenue estimated that the cost of collecting the income tax from persons with incomes of less than £250 was  $7\frac{1}{2}$  per cent.<sup>30</sup>

More recent estimates are found to be equally lacking in agreement. In 1920-21 the cost of collection of the tax from weekly wage earners was estimated to be 16 per cent of the yield and in 1928 it was estimated by Mr. Churchill that the cost had risen to about 33 per cent of the yield.<sup>31</sup>

It was hoped that direct inquiry from the Board of Inland Revenue would be more fruitful. Unfortunately, this was of little avail. The writer was informed that the statistical records of the income tax were not in a form that would permit any exact estimate to be made and that there was no prospect that this would be worked out in the near future. Although the tax on the weekly wage earner is assessed in a different schedule than the other parts of the income tax, it is assessed by the same inspectors' office and there is no effort made to isolate the expenditure for the weekly wage earner's tax from the rest. Although there was no official estimate of the cost of collection of this part of the tax, the statistical staff of the Board and the member of the Board in charge of the statistical work were agreed that the costs were large in proportion to the amount of revenue collected. The impression left with the author was that the administration did not consider the gross gain in revenue from the lower brackets to be of much significance in relation to the total revenue from the income tax and surtax and that, as a consequence, the costs of collection of this part of the revenue, whether large or small, were not to be bothered with. This neutral attitude toward an issue that would seem to be of greater

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<sup>28</sup> Comstock, Alzada, "British Income Tax Reform," *The American Economic Review*, Vol. X, No. 3, September 1920, pp. 488-506.

<sup>29</sup> Charles Edwards, M. P., *ibid.*, p. 493.

<sup>30</sup> *Minutes of Evidence of the Royal Commission on the Income Tax*, Cmd 288, Appendix No. 8, p. 73.

<sup>31</sup> Dalton, Hugh, *op. cit.*, note, p. 157.



importance may be explained in part by the fact that many members of the staff seem to have little concern with the question of the determination of the best policy to be followed, regarding themselves as the servants of Parliament to do the best that they can with the administration of the tax that is desired by the representatives of the people. Good administration seems to be the sole concern of these civil servants who are able to find a real life work in the service of the Board of Inland Revenue.

It may be concluded that, as far as it is possible to determine, the cost of collection of the personal income tax increases as the exemptions are lowered, but the amount of increase is dependent not only on the size of the exemption but also on the type of community, the rates in force, the quality of the administrative organization, business conditions, and so forth. The common measure of cost is unsuited for the purpose of comparisons of a simple nature. It would be desirable for the administrators to develop to the extent that it is possible the data on the cost-per-return as well as the more common cost-as-a-percentage-of-revenue measure. Knowledge that the costs of the collection of the income tax in the lower brackets are high is not a decisive factor by itself. However, unless there are other very cogent reasons for the use of the income tax, the high cost is to be considered a definite and perhaps compelling objection to the extensive development of the direct tax on small incomes. Certainly, until there are better data available than is the case at the present time, there is much to be said for a moderate reduction in the amount of the exemptions rather than a sharp cut that might raise costs to such a level that the more reasonable policy would be discredited.

**Collection at the Source.**—It has been suggested above that there are unique administrative problems and special difficulties to be faced in connection with the direct taxation of the small income. These difficulties may be thought of as being of two main types. One is the difficulty with which the individual taxpayer is able to meet a tax liability that is assessed infrequently. The second is the difficulty and costliness of the collection of a direct tax from millions of small taxpayers in employments

where there are weekly wages paid on an irregular basis depending on employment conditions. This state of affairs has led to the suggestion that a different type of collection technique is required in the lower brackets. Most frequently the suggestion has been that the adoption of a collection at the source technique would avoid many of the special difficulties.<sup>32</sup> The advantages and disadvantages of this type of administration must therefore be considered if conclusions as to the practicability of the lower bracket income tax are to be reached.

The possibility of the use of a gross or flat-rate tax collected at the source will not be considered. Although there are proposals that this is the only way there can be any effective direct taxation of the lower bracket income, it is so far removed from the present type of refined income tax that it is not believed to be sufficiently closely related to the true income tax to warrant its inclusion in this study.<sup>33</sup>

The advantages of the use of collection at the source are many. First, the difficulties which the wage earner finds in paying the lump sum tax under the usual type of tax can be avoided. Even though the income tax is payable quarterly, if the rates are substantial the worker will find it difficult to pay. If there are shorter periods between the time of assessment and collection of the full amount, the worker is in an even worse position.

The proponents of the use of the source method of collection differ as to the exact technique to be used, but it is the general belief that any type of source collection will be to the advantage of the taxpayer. The usual scheme is to have the employer deduct the tax from the wage that would normally be paid. If

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<sup>32</sup> The following statement is typical:

"A withholding levy on taxable salaries up to \$5,000 will be proposed to a House tax sub-committee by Chairman Vinson, Dem of Ky., as a means of simplifying the revenue system.

"The plan would eliminate the requirement that small taxpayers file income tax returns. Instead, their employers could hold back part of their earnings, as is done now with social security assessments, and pay the money to the Government as taxes

"A withholding tax would be almost imperative, this official (Treasury) said, should the United States ever find it necessary to lower the tax base or reduce exemptions." (*New York Times*, September 23, 1937)

<sup>33</sup> The successful administration of the social security old-age taxes indicates that in the covered employments there are no special difficulties.

the wages are paid weekly, the tax will be deducted weekly; if the wage is paid monthly, the tax is to be deducted monthly; and so on. In this way the employee will never have to bother with building up a savings account to meet the tax when it falls due and can budget on the basis of the pay envelope as he did before the tax was imposed. It is also claimed by some that not only does this avoid the difficulties of the infrequent payment that must be anticipated by the poorer taxpayer but that it has the advantage of the indirect tax that has made it such an important source of revenue, that is, the ability to raise large sums with the minimum of feeling of hurt on the part of the taxpayer. Although this argument is directly opposed to the idea that the income tax should be used for the development of tax consciousness, it may of course still carry great weight with the financier concerned with the problem of obtaining the greatest amount of revenue with the least difficulty.<sup>84</sup>

The second great advantage claimed for the source method of collection is that this is the only possible way to assure that the cost of collection of the income tax from the wage earner is not prohibitive and at the same time be sure that there is not extensive evasion of the tax. If the employer can be made to assume a part of the costs, the government naturally will stand to benefit. The check that this type of collection gives is also believed to result in saving by preventing the administrative cost of following up the wage earners who are believed to be evading the tax.

Although there is little doubt that the use of the collection at the source method will result in saving, and less evasion if the tax is assessed at a flat rate with no allowances for the individual differences of the taxpayers—in other words, if it is a wages tax

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<sup>84</sup> The following comment is made in an article on the use of collection at the source in South Australia: "The scheme is still in its infancy, but the general feeling in South Australia is one of satisfaction, on the part of both the Government and the taxpayers. It suits the majority of taxpayers, who find a difficulty in paying the heavy tax in one lump sum at 30 days' notice, which owing to the frailty of human nature, always seems far too short. To put it briefly, the method has given our most important direct tax, the feature that has always made indirect taxes so dear to the hearts of financiers—the feature of causing the minimum of 'feeling of hurt' to the victim." (Hyttén, T., "Collecting Income Tax at the Source," *The Economic Record*, Vol. VIII, No. 15, December 1932, pp. 278-281.)

comparable to the present social security tax in this country—it is of doubtful value on the economy side if there is to be full allowance for the individuals' standing from all points of view. Although it would make evasion more difficult, the adjustment at the end of the fiscal period for the individual differences would require a complete return comparable to the one in use today and would in addition require that there be refunds made to the taxpayers who were able as a result of the allowances to claim a reduction in the tax liability.<sup>35</sup>

It is possible that this difficulty of rebates could be avoided and the advantage of the use of the source method made greater if the employer were informed of the proper claims for allowances of the taxpayer and could adjust the wage deduction accordingly. However, there are many reasons why this would not work well in practice in the United States. In the first place, the employee would almost certainly object to the granting to the employer of information as to his personal income tax status. The employee is not willing to have his employer know that he has income from other sources and may not want him to know about his other personal affairs.<sup>36</sup> Even if this infor-

<sup>35</sup> The report of a committee of the National Tax Association on "A Plan of a Model System of State and Local Taxation" contains the following criticism of source taxation: "We repeat the recommendation of the former Committee that the personal income tax be collected from taxpayers, upon the basis of strictly enforced and controlled returns, and without any attempt to collect it at the source. Upon this point there might have been doubt twenty years ago, but subsequent experience has settled the question. . . . Collection at source presents serious administrative difficulties, imposes unwarranted burdens upon third parties in respect of transactions which strictly concern only the taxpayers and the government, and not infrequently tends to shift the tax to the wrong shoulders." ("Second Report on a Plan of a Model System of State and Local Taxation," *Proceedings of the National Tax Association, 1933*, Columbia, S. C., 1934, pp. 353-420.)

<sup>36</sup> The attitude of the workers in England is against the granting to the employer of information of a personal nature. The following testimony before the Royal Commission on the Income Tax is of interest: "The bill which became law as the Finance (No. 2) Act, 1915, contained, when introduced, a clause providing that if the weekly wage-earner failed to pay the tax due from him his employer should be empowered to deduct the amount from his wages and pay it over to the Revenue. When that claim came up for consideration on the Committee Stage of the Bill, a storm of protest arose, both from employers and from workmen, and the Chancellor of the Exchequer agreed to ascertain the views of all parties affected at a representative conference to be summoned by him. The conference took place on the 3rd December, 1915, when representatives of the employees advocated the direct assessment of the individual weekly wage-earner, as is the case with

mation were to be given to the employer there would still be the necessity of making numerous adjustments at the close of the fiscal period. This would be true as the claims for special allowances do not fall evenly throughout the year but may come at any time. It may be objected that this difficulty would not arise if the tax were computed on the basis of one year's work and the liability discharged in the following year when the amount due was known. This would be impractical, however, as the ability of the wage earner to meet a tax on the income of the previous year might be removed by the fact that he had lost his job or had had to take a pay cut.

The final point that is raised in favor of the use of taxation at the source is that, because of the frequency of the payment, it would assure the treasury of a steady flow of revenue throughout the year, removing the necessity of borrowing in the open market to obtain funds between collection dates. This would, however, become of real significance only if the use of the frequent payment plan were to be extended throughout the entire tax structure. The increase in the regularity of the revenue obtained from the lower bracket income tax would not be of particular significance in the total picture. There is even some doubt as to the steadiness of the flow of revenue in the lower brackets if the settlement at the end of the period resulted, as it is believed it would, in large refunds at the close of the year. Unless the credit of the government is weak, short-term financing is not necessarily bad. In the one case the people are deprived of their funds until the refund is made, losing the interest on this money, and in the other case the cost of the interest on the short-term requirements of the government is met by the imposition of a slightly higher tax than is required for the meeting of the interest charge payable to the banks. There does not seem to be much to choose between these two alternatives.

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other classes of industrial employees, and expressed their entire disapproval of any scheme which would result in disclosure to an employer of a workman's private affairs. The attitude of the employers was understood to be, that to make them tax-collectors in respect of wages paid would lead to friction between them and their employees." (Statement of E. R. Harrison, Assistant Secretary to the Board of Inland Revenue, *Minutes of Evidence of the Royal Commission on the Income Tax, op. cit.*, #25, p. 91.)

Some other disadvantages of a source method of taxation are equally pressing. Not only does the employee dislike the possibility of the taxation of wages at the source if he believes that it will necessitate the giving to his employer of information about his personal financial status, but the employer may object that regardless of the actual use of this information the workers will resent it and it will become a source of bad feeling between the employer and the employee. The employer will also object to the source method of taxation if he is expected to add to his work in the collection of the tax without some compensation from the government. The cost to the employer will, of course, differ from case to case but there is the distinct possibility that in cases of large employers of manual labor the additional cost would be considerable. If the objection of the employer is met and he is to be compensated for the additional work involved, there is no longer the advantage of the collection at the source as an economy measure.

Another objection is that the collection at a flat rate with the provision for adjustment at the end of the fiscal period will work hardship on the taxpayer who has a large sum deducted and held by the government until the final adjustment is made. This hardship is in addition to the loss of the interest on the money which is probably not nearly so important in the lower brackets as the fact that the wage earner is usually in need of every penny that he can lay his hands on at the time when he is earning his wages.

A still more serious objection as far as the wage earner is concerned is that there is the possibility that the use of the collection at the source will lead to the taxation of gross income at a proportionate rate after the difficulties with rebates and the employers have been realized. With the minor exception of small allowances for family status, this is what happened in Germany.<sup>37</sup> Although the taxation of gross income might be better than the present system of indirect taxation on the wage earner, he would object more certainly to the obvious failure to recognize the difference in ability that the use of the gross tax implied.

<sup>37</sup> See page 191.

The applicability of the collection at the source technique may also be objected to on the ground that although the creation of tax consciousness by the use of the direct tax on small incomes is uncertain, there is still a powerful group who would not favor the tax at all unless it were believed that there was some hope of its providing the basis for the development of an intelligent type of tax consciousness. Certainly, the collection at the source does not promote nearly as much potential tax consciousness as the direct assessment. With the use of a source technique requiring the deduction of the tax from wages on a weekly basis, there is probably very little tax consciousness of any sort that can be said to arise from this payment that is never placed in the hands of the wage earner. Even though the worker were informed each week that the deduction is due to the tax, there would be probably very little reaction after the provision had been in force for a year or more. It would also make the administration more hesitant to make the frequent changes in the rates that should be made if the maximum amount of consciousness is to result.

In spite of the many objections to the use of deduction at the source there is the possibility that it would prove more practical than the alternative of separate assessment and collection. It may be that the collection of the tax at the source is to be accepted or the lower bracket tax not adopted at all. There are, however, limits to the extent to which the tax may be used. The small shopkeeper cannot have the tax deducted at the source nor can the independent farmer, contractor, or any other person who is primarily working for himself. As suggested above in another connection, this group is large enough to present special difficulties of evasion and failure to be aware of the liability for the tax that is due. Collection at the source may be helpful but it can by no means be considered a panacea for the difficulties that must be encountered when there is an attempt to include the small incomes within the scope of the income tax. Where it might be very helpful in the highly industrialized areas with a large percentage of the lower paid workers in factory employment, the collection at the source technique would probably be of little assistance in the area with the distribution of occupa-

tions such that the majority of the lower income group would be farmers or farm laborers.

The existence of a large body of poorly paid workers in pursuits other than those providing remuneration in the form of weekly wages or on regular payrolls suggests that the national government might find it even less advantageous to adopt the collection at the source than some of the states with a large industrial population. For example, collection at the source might prove to be very helpful in New Jersey but not at all practical in North Dakota. Although the maintenance of uniformity of administration in the tax system is desirable, it does not seem illogical to think of a compromise at this point with collection at the source being used in the areas where it was clearly to the advantage of the government and the usual type of tax being used elsewhere. Care would of course have to be taken to be sure that there was no difference in the interpretation of the basic law under the two types of administration. The basis for the determination of the type of collection procedure would be important, as the resentment of arbitrary ruling might work against the best interests of the government. Although the reaction of the wage earner to the use of collection at the source is uncertain, there might be an attempt to have the popular will of the taxable wage earners determine the policy to be followed.

**Type of Administrative Organization.**—It is a well-accepted maxim that a law is no better than its administration. In no case does this maxim hold more certainly than in the administration of an income tax in the lower brackets. Aside from the special problems of the type of law necessary for efficient administration there is to be considered the type of organization best suited for the difficult problem of the carrying out of the will of the legislature. In the simplest terms, what is desired is an administrative organization that is efficient, fair, and capable of finding a workable solution to the special problems not anticipated by the legislature. Much of the most useful work in this field is done by the actual administrator faced with the particular problem to be solved. However, the best staff will be unable to act



efficiently unless the organization established permits the use of sufficient discretion. Some of the requirements of a good organization for the administration of the lower bracket income tax will be considered below.

In the first place, the merit of the administrative organization is largely dependent on the qualifications of its personnel. Gaston Jeze believes that "No system of administration is complete without a trained and reliable personnel, the recruiting of which is a task equal in importance to that of proper organization itself."<sup>38</sup> The best way of assuring the fulfillment of this requirement is not within the scope of this study. There is, however, reason to believe that this type of personnel will not be obtained without the provision of opportunity for the pursuance of a career in the financial service of the government and the provision of incentives in the form of wages and possibility of promotion comparable to those of persons engaged in similar work in private enterprise. Specifically this requires the development of the civil service in such a manner that greater flexibility in the range of job may be obtained. This is of special importance in the federal department of internal revenue where the selection of the income tax personnel is at the present time weakened by appointments on a political basis.<sup>39</sup> The need for the maintenance of adequate incentives was emphasized by the Joint Committee on Internal Revenue Taxation in a report made in 1927, as follows:

The bureau loses regularly a large percentage of its ablest employees because it cannot meet the terms offered by others. A certain amount of this leakage is inevitable. But the present turnover is excessive. Surely the bureau should be able to compete with the services of efficient employees whom it desires to retain with State tax commissions and business concerns of moderate size.<sup>40</sup>

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<sup>38</sup> Jeze, Gaston, "Financial Administration," *Encyclopaedia of the Social Sciences*, Vol. VI, New York, 1931, p. 234.

<sup>39</sup> Investigation reveals that the 2,500 deputy collectors of internal revenue in the field are political appointees and are expected to be replaced with a change in administration.

<sup>40</sup> *Survey of the Administration of Income and Excess-Profits Taxes*, Vol. III of the Report of the Joint Committee on Internal Revenue Taxation, Washington, 1927, p. 4.

With a good personnel a bad law may conceivably be administered effectively, but with a poor personnel a good law is bound to prove unsatisfactory. As cooperation of the taxpayer is necessary for the effective administration of the personal income tax, there is also need to include in the training and selection of the men to meet the eventual taxpayer a sense of tact and ability to inquire into the personal affairs of the taxpayer with the minimum of offense to him.

The second point of administrative importance is provision of sufficient flexibility in the system so that there is not the waste of time and effort and the unnecessary irritation to the taxpayer that is likely to accompany the maintenance of over-elaborate regulations and meticulous adherence to the letter rather than the spirit of the law. At the same time it is necessary to realize that uniformity is important in the administration of a successful law. The administration must not be so strict in the interpretation of the law as to lead to hardship and bad feeling but it should be equally on guard against the danger of inconsistency and the inequity that is bound to result from the failure to follow a positive policy. The drawing of this line between no flexibility and too much is an art that is the gift of the good administrator but cannot be determined successfully in advance.

The Joint Committee on Internal Revenue Taxation reached the following conclusions as to the nature of the administrative problems of the income tax:

1. At root, the major problem is one of personnel.
2. All tax cases cannot be closed up on the basis of absolute accuracy. To attempt to do so is to sacrifice accomplishment to unattainable ideal. Prompt and final settlement is often more important than meticulous accuracy.
3. The collection of revenues is primarily an administrative and not a judicial problem. As far as the Federal income tax is concerned, a field of administration has been turned into a legal battle field.<sup>41</sup>

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<sup>41</sup> *Ibid.*, p. 3.

Stamp is also well aware of the dilemma that the granting of discretion to the administrator presents. He summarizes the problem very well in these words :

I have said just now that just as the law itself should apply equally to all subjects coming under it, so there is an obligation that the discretionary application super-added to the law by those who "work it" should be uniform and not erratic. The real problem is, having to discharge legal functions executively, through a large number of agents, how on earth are you going to make those agents act with one mind.<sup>42</sup>

The determination of the best compromise is particularly difficult in the lower brackets. The decision of an administrative agent on a question of the proper deduction or the total amount of taxable income will be, in many cases at least, one that will determine whether the individual concerned has, what is for him, a heavy tax to pay, or is to be relieved of all income tax for the year, or may be one that will relieve a whole class of taxpayers from the necessity of paying an income tax. In this connection the decision noted above, that the agent of the Board of Inland Revenue in England makes with respect to the size of the allowance to be granted to the members of a trade union for tools and special clothing, is a good example. It is to be noted, therefore, that the lack of dispute over the final allowances granted would indicate that in this respect at least the proper compromise has been worked out in that country.

A problem closely related to the degree of flexibility desirable is the degree of centralization in the administrative organization that is conducive to the maximum efficiency and the proper amount of flexibility. At the one extreme there is the possibility of a highly centralized administration with the sole authority to make decisions left in the hands of the central office; at the other is the administration where the interpretation of the law and the decision as to policy is left in the hands of separate agencies organized on the basis of local population centers, there being no central coordinating office.

<sup>42</sup> Stamp, Sir Josiah C., "Administration of Business and Public Affairs," *The Journal of Public Administration*, Vol. I, 1923, pp. 158-171.

In a country of this size the impracticability of either of the extreme alternatives is well recognized. There is, however, considerable doubt as to the exact position that is the most effective under the present income tax. With the lowering of the exemptions, there would be many millions of new returns to assess and collect. In face of this change it is believed that it is wise to follow a policy of decentralization. It is necessary, however, to maintain a strong central organization to assure that there was the maintenance of uniform standards throughout the country.

The need for a high degree of decentralization arises because it is essential to have a man on the spot who is familiar with the local community and the residents of the community to assure a complete coverage of the persons liable to the income tax. He must have considerable authority to prevent the costly and slow process of basing each decision on advice from the central authority. Periodic checks may be made to assure the maintenance of uniformity but the main job must be done in the field where the taxpayer resides and the local administrator can make the decisions necessary on the basis of as complete information as is possible to obtain. Even in the settlement of the large tax returns where the sums involved are often very large, the bureau of internal revenue has been following recently a policy of decentralization.<sup>43</sup>

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<sup>43</sup> A trial regional office was started early in 1938 in Los Angeles with authority over all tax collection in Southern California and Arizona. This proved a success and the decentralization of the whole revenue system is now under way with the expectation that it will be in full operation by June 30, 1939. Secretary Morgenthau made the following statement with respect to the program at its inception:

"We think this arrangement will eliminate many repetitious steps and protracted delays which it seems impossible to avoid under the present plan of centralized consideration and settlement of tax disputes in the Bureau at Washington. It will permit prompt action on all contested cases, at a point near to the taxpayer and to the sources of evidence regarding his transactions.

"It will provide, even for the small taxpayer, an able and impartial administrative body to which he can have ready recourse should he be dissatisfied with the findings of the agency which examined his return in the first instance. In short, we think it will result in fairer treatment and greater convenience to taxpayers, in quicker administrative decisions, and in fewer appeals from the Bureau to the Board of Tax Appeals and the Courts. The plan will be of special benefit to taxpayers who are financially unable to employ expert counsel." (Press Service Release, Treasury Department,

However, without a personnel with the proper training it is impossible to turn the administration over to local offices. It is also necessary to maintain a local personnel free from political pressure or from obtaining too close a loyalty to the members of the local district.<sup>44</sup>

The development of the first truly successful state personal income tax was a result of the recognition of these basic principles. In a recent study of state income taxation, Blakey makes this interesting comment:

The National Tax Association committee on the model plan of state and local taxation, in calling attention to Wisconsin's successful income tax, lays no small stress on the work of the district assessors, who are "bringing the administration of the law home to the people of the several districts. . . ." These district assessors, it should be kept in mind, are appointed by a central state authority and are responsible to that authority; their tenures not dependent on the votes of their districts.<sup>45</sup>

The natural movement of the population requires, of course, the coordinating of the separate local administrations. Too little centralization may result in as much inefficiency as too much. As the best policy can be determined most satisfactorily in the field, care should be exercised to preserve the necessary flexibility.

Although there may be slight differences in the specific problems of the state as compared with the federal government, they are essentially the same and similar requirements apply. It is suggested, therefore, that there is good reason, on administrative grounds, to consolidate the two administrations. The economies would be great and the possibility of the attainment of an efficient, equitable system might be aided by the concerted

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Washington, D. C., February 17, 1938; cf. Treasury Department Press Service Release, December 7, 1938, and the *New York Times*, May 5, 1938.)

<sup>44</sup> The following comment was made by the Supervisor of the Income Tax Department of Montana. "The fact that the law is administered locally and the administrative staff so widely known all over the state leads taxpayers to take undue advantage of their acquaintances. This leads to procrastination." (Letter of May 13, 1937, written to the author by L. C. Burns, Supervisor of Income Tax Department, State Board of Equalization, Helena, Montana.)

<sup>45</sup> Blakey, R. G., *op. cit.*, pp. 493-494.

effort of the two governments. The effect of this proposal on the political situation is not considered, although it is of course of equal importance in the determination of the actual policy to be followed. It is also true, however, that the consolidation of the state administration with the federal or the federal with the state would tend to diminish the distinction between the two governments for the purposes of the creation of tax consciousness.

It may be concluded that the problems of the type of administrative organization best suited to administer the lower bracket income tax are difficult but not insoluble. Much depends on the attitude of the citizen toward the reform of the government service as this problem of the administration of the income tax is only a part of the larger problem of the improvement in the level of administration in the government as a whole. The eventual success of any tax measure depends on the cooperation of the great majority of the citizens. This will come, however, only with improvement in administration.

### Social Security Taxation

The recent development of the social security program in this country makes it desirable to consider its relation to the administration of an income tax. However, it has been suggested above that the employee income tax under the social security act imposed to finance the old-age benefits or annuities does not conform to the general principle of personal income taxation. In the first place it is a tax that is earmarked for the special purpose of the payment of the old-age benefits, which benefits are related to the amount of tax paid. In the second place it is a tax that is paid on gross *wages* in certain covered employments. Income other than wages is not included and there are no deductions or exemptions comparable to those under the personal income tax. Excluded from the scope of the tax are wages in excess of \$3,000, all professional and self-employed, agricultural labor, domestic servants, casual labor, persons over 65 years of age, maritime workers, government employees, and persons employed by religious, charitable, or educational institutions.<sup>46</sup>

<sup>46</sup> See Social Security Act, Ch. 531, 49 Stat. 620, Title VIII.

With the exception of government employees and persons living on investment income, these exclusions are to be justified on the ground of administrative expediency. The result is that approximately one-third of the persons gainfully employed are excluded from the program.<sup>47</sup>

Although the difficulties of assessment and collection of the old-age income tax are not as great as the more refined personal income tax, it is of interest to note that it was originally believed to be administratively impracticable to include a large part of the gainfully employed. The fact that the recipient of the smallest wage is included in covered employments adds to the difficulties, but on the other hand the lack of varying exemptions and use of the gross wage as the tax base should make the administrative task less complicated. One cannot draw too many conclusions from the administrative experience of the wage tax, however, as the direct connection between the tax paid and the amount of benefit payable at the age of 65 may have the effect of creating an incentive for the employee in the covered employments to see that his employer makes the proper deductions from wages and pays the tax on his payroll. Although there are many employees who will have no interest in their eligibility, it is probably true that the majority are in favor of the plan and realize that the additional returns which arise from the employer contributions assures a future annuity sufficiently large to compensate for the present sacrifice in wage tax. There may be fewer who will maintain this view if the wage tax is eventually raised to the maximum of 3 per cent as provided under the social security act.

The reaction of the employer to use of the source technique may differ if it is used to finance the payment of old-age benefits rather than a general personal income tax. In the first place many employers have come to recognize the need for some type

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<sup>47</sup> The original estimates of coverage were that about 53 per cent would be included. Because of the failure to make adequate allowance for the turnover of labor from uncovered to covered employments, the estimates were low. (See *Third Annual Report of the Social Security Board*, Fiscal Year Ended June 30, 1938, Washington, 1938, p. 27; cf., Statement of Arthur J. Altmeyer, Chairman, Social Security Board, at Hearing on Social Security Legislation before the House Ways and Means Committee, February 1, 1939.)

of old-age pension. The extensive private plans of this type in force before the enactment of the federal legislation bear witness to this fact.<sup>48</sup> In the second place many employers see the logic of connecting the pension and the wages received. It may be argued effectively that any other type of tax except an income tax would lead the worker to believe that he was getting something for nothing and possibly lead to the adoption of a variation of the Townsend plan which would be even more costly in the end.

The case for the employers undertaking to assist in the administration of the personal income tax in the lowest brackets may be made on the same general grounds but less effectively. As indicated in the discussion of tax consciousness, even the payment of a direct tax for the general functions of government may not be connected with the benefits received in such a way that it will have a predictable effect. The personal income tax would also require more complicated records. Although there are some employers who would be willing to undertake considerable additional cost if there were to be enacted an income tax including a large part of their labor force, it is likely that the great majority in this country would favor it only as a last resort. If it is suggested only as a means of improving the distribution of the tax burden, they would probably favor the continued use of the existing sales taxes, excises, and general property taxes. Although employers are in a minority they could protest against the inequity and obvious difficulties of the source method of taxation of incomes and become effective in a movement to prevent the enactment of such a measure or its repeal.

The restriction of the scope of the social security program and the other differences noted above makes a study of the administration of the tax of only limited interest for the purposes of this analysis. Although the social security benefits are determined and distributed by a distinct separate social security administration, the collection of taxes is the function

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<sup>48</sup> In 1930 there were about 420 plans in force affecting approximately 3,500,000 workers. (See *Social Security in America*, Social Security Board, Publication No. 20, Washington, D. C., 1937, p. 172.)



of the bureau of internal revenue, the same administration responsible for the collection of the personal and corporate income tax. Consultation with members of the staff of the bureau indicates that there has not been any special difficulty experienced in the collection of the taxes to date. Extensive use is made of corporation income tax returns, and it is also possible to check on any but the smallest employer by finding the returns that have deductions from gross income for wages paid. The small shopkeeper and others who do not maintain full accounts have presented some problems of enforcement and there are some problems in connection with wrong returns and the settling of the exact scope of the tax liability. However, these difficulties are not believed to loom large in the total picture.

Much of the current discussion of the social security program is centered on the problem of increasing the persons given substantial benefits. This has led to some interesting proposals with respect to the financing of the additional benefits. The Advisory Council on Social Security,<sup>49</sup> the Social Security Board,<sup>50</sup> and the President<sup>51</sup> are all agreed that the scope of the old-age provisions of the act should be broadened. However, if the farm laborer, domestic servant, casual laborer, and the self-employed are to be included, new techniques would be required. At the present time there is little chance of including the casual laborer or the self-employed because of the administrative difficulties involved. There is, however, real chance of including the farm worker and the domestic servant. The exclusion of state and federal employees is to be justified, of course, on other grounds than administrative expediency.

As there is already established the wage base in the covered employments, a comparable base for the newly covered employments is necessary unless the whole act is changed. This excludes from consideration the use of an income tax based on the principle of ability. Special problems are also created in the case of farm labor with respect to the treatment of income

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<sup>49</sup> See *Final Report of the Advisory Council on Social Security*, December 10, 1938.

<sup>50</sup> *New York Times*, January 17, 1939

<sup>51</sup> *Ibid.*

paid in goods and services rather than cash. This is particularly difficult in the case of domestic service where it is common for the servant to receive a part of his wage in the form of board and room. Additional difficulties are to be anticipated because of the large number of employers in relation to employees. Not only does this mean a more than proportionate increase in the number of tax returns but it is also the small employers who are least likely to maintain wage records in a form which would assist in the preparation of the employer's return.

The most logical form of collection of the wage tax in the now uncovered employments would seem to be some sort of stamp system.<sup>52</sup> This would avoid the difficulty of the maintenance of elaborate records on the part of people not in the habit of doing this type of work and would assist the worker in enforcing the payment of the tax on the part of the employer. There would also be the salutary effect of the maintenance of the direct connection between the tax and the benefit payable upon retirement. If this type of program were to be incorporated in the case of farm labor and domestic service, there would also be the possibility of permitting the use of the stamp plan by the small business man who is the only real problem with the present coverage.

The use of the wage base presents an interesting dilemma if the self-employed are to be included. The question is what may be the closest approximation to the wage base used in the other employment. Although the economic theorist may distinguish between the return to the owner of an enterprise that is for services rendered, it is as a practical matter a most difficult task. This becomes even more difficult when the self-employed does not even have records which will accurately determine his net profits for the year or even his cash receipts.

Some persons believe that the wage taxes are not to be justified even for the purposes of financing the old-age benefits because they are regressive and it is administratively difficult to provide full coverage. They suggest that the problem could be met by the imposition of an income tax based on the ability

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<sup>52</sup> This is suggested by Mary Dewson. (See Dewson, Mary W., "Next Steps in Social Security Legislation," *Social Service*, March 1938, pp. 24-26.)

principle or some self-assessed tax connected with the income tax. Although self-assessment of a tax which determines the size of the benefit to be received might create the unusual problem of overassessment, if the benefits are to exceed the taxes paid in the lower brackets, one of the proposals is of particular interest. It is, of course, understood that if such a revision in the financing of social security benefit for the aged is to be undertaken, it would be a complete revision of the whole program, not simply restricted to the new uncovered employments.

This alternative scheme is proposed by J. Frederic Dewhurst and arises from his analysis of two proposals of committees of the Twentieth Century Fund. First, "the proposal of the Committee on Old Age Security . . . for wider coverage, more adequate old-age pensions and a more equitable distribution of their cost, and second the proposal of the Committee on Taxation . . . that the income tax base be broadened and its yield increased by drastic lowering of exemptions so that tax consciousness can be increased and the cost of government can be distributed more nearly in accordance with ability to pay."<sup>58</sup> The essentials of the proposal are simple.

All single persons receiving gross annual income of \$500 or more would be required to file annual income tax returns. All married couples receiving gross annual of \$1,000 or more (irrespective of dependents) would be required to file *joint* income tax returns. A tax of 3 per cent on gross annual income (excluding any amount over \$3,000) would be collected from all persons or couples filing returns. The amount of gross tax paid would be credited in the Treasury to the account of the individual and would provide the basis for determining the pension to which he would be entitled on retirement. In the case of married couples, half of the tax paid would be credited to the husband and half to the wife, irrespective of the source of the family income. Net income taxes would be assessed as at present, but the exemptions would be lowered to \$500 for single persons, \$1,000 for couples and \$200 for each dependent. This would mean that, except for low-income married couples with children, *virtually all persons required to pay*

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<sup>58</sup> Dewhurst, J. Frederic, "Old-Age Security Financing in Relation to Income Tax Reform," *The Bulletin of the National Tax Association*, Vol. XXIII, No. 8, May 1938, p. 240.

*the gross income pension tax would also be subject to at least a small net income tax.*<sup>54</sup>

This proposal has two obvious administrative advantages. First, it would spread the cost of the administration between two levies, and second, it would provide an incentive for accurate reporting of income on a voluntary basis if it is believed that the public is sufficiently well informed about the old-age pension system and is willing to make a small sacrifice from current income to enjoy a future gain of a substantial amount. As it is suggested in the same article that considerable reliance be placed on the general revenue system for the financing of the pensions and that the employer's tax be retained, there would be even greater gain to be realized from the investment in current tax payments than is now the case. Although the accompanying income tax would serve as a check, there would still remain the problem of the over-reporting of income for the purpose of increasing future benefits. The use of the gross income base would also be advantageous as it would solve the problem of the equitable treatment of the self-employed.

On the adverse side there are, however, still many objections to the proposal. With respect to costs of administration it is still doubtful that they might be kept at a reasonable level. The change from the collection from the employer to the individual employee in each case would multiply the number of returns to be handled many times. In general most of the administrative problems discussed above would remain even though the individual was desirous of making a return. There is also the problem that is not of particular concern in this study but which merits attention: that of the increase in the difference between the contribution paid directly and the pension paid. To prevent the voting of excessive pensions, there is still much to be said for the maintenance of the close relationship.

It may be concluded that the present system of social security taxation is so specialized that there is little specific information to be gained from the study of the experience in the administration of this act, if the primary consideration is the general

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<sup>54</sup> *Ibid.*, p. 242. (*Italics his.*)

taxation of lower bracket incomes. However, many of the problems are so similar that there is much to be gained from the understanding of the social security problem. This will probably be increasingly true if the present suggestions for the broadening of the scope of the program are enacted. As the social security program develops, it may also pave the way for income tax reform by creating new attitudes and the provision of vital information.

### The Taxation of Small Incomes in Great Britain

Passing reference has been made already to the direct taxation of small incomes in Great Britain. However, the experience of the British is of such importance that it warrants a more thorough study. The British tax system is often misunderstood and there is a tendency to believe that the exemptions under the law are lower than they are in fact. It is nevertheless true that the British income tax is more inclusive than the American and that the experience of the British in the administration of a law of this type is to be considered of value to the American interested in this problem.

In the first place, a few words about the British law are necessary if the place of the administrator in Great Britain is to be understood. The present taxation of incomes dates back to the passage of the Income Tax Act, 1842. This Act is based on the Statute of 1806, the last revision of the original income tax imposed in 1799 by the younger Pitt. All subsequent income taxation legislation has been developed around these basic laws.<sup>55</sup> The first major change was made by the Act of 1853, and from this date on numerous changes were made by separate Acts of Parliament but no new basic law was enacted until the year 1918.

The complexity of the law became greater and greater. By 1918 "no fewer than fifty-two Acts of Parliament existed to embarrass the taxpayer and his advisers and the officials whose business it was to administer the tax. No general revision

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<sup>55</sup> *Report*, Income Tax Codification Committee, London, 1936, Vol. I, Cmd. 5131, pp. 9-11.

of the legislation had taken place since 1853 and few overlapping or obsolete provisions had been repealed or recast.”<sup>56</sup>

In 1918 there was passed the Income Tax Act, 1918, which was supposed to consolidate the two basic Acts of 1842 and 1853 and bring into one law the material added by the subsequent legislation. Although this was done in the legal sense “it did little to eliminate overlapping or inconsistent provisions, and practically nothing to bring the law, either in substance or in language, into accord with modern conditions.”<sup>57</sup> It is this Income Tax Act, 1918, that has since that date been the principal Act on which the law is based and which the administration must endeavor to interpret. Since 1918 there have been continued modifications in the annual Finance Acts until the situation now is worse than at the time of consolidation in 1918.<sup>58</sup>

On top of this mass of legislation there have been added the decisions of the courts until even the experts on the law become lost in the interpretation of the exact meaning of the combined legislation and court interpretation. The following conclusion has been reached by the Codification Committee appointed to try to draft a suitable tax bill:

The Statutes and the decisions of the Courts are printed and accessible, but the Committee has also had to take cognisance, as explained above, of a large amount of income tax practice, on which detailed information has been furnished to us by the Board. It is not too much to say that, were it not for the good sense and reasonableness shown by the Department in the practical application of our income tax system, and in devising expedients for making good its deficiencies and omissions, it would at many points have proved unworkable; but, while we have admired the methods thus devised for enabling the system to work, the existence of this large body of informal practice has added another complication to the task of codification.<sup>59</sup>

The part played by the administration is emphasized by another student of the British law.<sup>60</sup> Spaulding makes the point

<sup>56</sup> *Ibid.*, p. 10.

<sup>57</sup> *Ibid.*

<sup>58</sup> *Ibid.*, pp. 10-11.

<sup>59</sup> *Ibid.*, pp. 15-16.

<sup>60</sup> Spaulding, H. B., *The Income Tax in Great Britain and the United States*, London, 1927, p. 247.

that even the functions of the various officers of the administration have been changed without legislative modification of the basic law.

In view of this situation there is little possibility of presenting in simple form a complete and detailed exposition of the British law as it affects the small income. There are, however, many points of such interest that an understanding of the general nature of the British practice is believed to be helpful.

The administration of the British law differs from the American in many respects but it is essentially a tax on the total income of each taxpayer and, on the whole, it resembles the American tax in its final effects. One of the most important differences in the administrative set-up is the use of the separate schedules for the assessment of different types of income and the more extensive use of collection at the source than is the case in the United States. These schedules are for administrative convenience only, as the final liability is always figured on the basis of the total income from all sources. Under Schedule A is assessed income from the ownership of lands and tenements; under Schedule B is assessed income from the occupation of land; under Schedule C is assessed interest, dividends and annuities payable in the United Kingdom; under Schedule D is assessed profits from trades, professions, employments and vocations, income from foreign securities and foreign possessions, and any annual profits not charged under any other schedule; and under Schedule E is assessed income from public offices or employments of profit, and of annuities, pensions, and stipends payable by the Crown or out of the public revenue of the United Kingdom.<sup>61</sup>

It is under Schedule E that the greater part of the income tax in the lower brackets is assessed. Although there are obviously small incomes returned under the other schedules, it is the wage earner who is the regular and consistent recipient of

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<sup>61</sup> *Ibid.*, p. 240. For other descriptions of the British law, see Magill, Roswell, Parker, L. H., and King, Eldon P., *A Summary of the British Tax System*, Washington, U. S. Govt. Printing Office, 1934. See also Bernard, André, *Taxation of Incomes, Corporations and Inheritances in Canada, Great Britain, France, Italy, Belgium, and Spain*, Washington, U. S. Govt. Printing Office, 1925.

the smaller income. As the number or proportion of small independent farmers is not nearly as great in Great Britain as in this country, the problem of dealing with them under Schedules A and B is not great. It is also true that as the annual rental value of all real estate is the basis for the local rates in Great Britain, this affords the income tax authorities a basis for the determination of the proper tax on this type of income with the minimum difficulty. Although this has the effect of including in the taxable income, income realized in other forms than cash, the taxpayer has the opportunity to appeal and obtain a lower assessment if it can be shown that the actual profits are less than the annual value.

Although with respect to income received from interest, dividends, and rents the British apply the source method of collection with the provision for later adjustment, collection at the source is not generally used in the assessment of incomes under Schedule E. However, assessment differs in one important respect from the practice in the United States. This difference is that although the taxpayer is required to return all income to the assessor, the final tax liability is computed, not by the taxpayer as is the practice in the United States, but by the government. As is the practice in this country, extensive use is made of information at the source with respect to this class of taxpayer and records for each taxpayer are maintained over a period of years.

Recognition of the special problem of the lower bracket income is made by the creation of a special class of taxpayers under Schedule E. These taxpayers are known as "weekly wage earners" and includes all persons employed by way of manual labor <sup>62</sup> "who receive wages which are calculated by reference to the hour, day, week, or any period less than a month, at whatever intervals the wages may be paid, or who receive wages, however calculated, which are paid daily, weekly, or at any intervals less than a month." Also for the purposes of the

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<sup>62</sup> "Manual" labor includes all occupations which depend mainly on the exercise of physical exertion, even though a considerable amount of dexterity and training may be involved.



administration, government employees and railway workers are included in this general classification.

There are two special provisions for this class of taxpayer. The first is the requirement of half-year assessment and collection and the second is the permissive use of Income Tax Stamps to settle the tax liability. These stamps may be used by the weekly wage earner in cases where the tax payable exceeds 6s. and may be affixed weekly to a special card to spread the payment over a period of 13 weeks.

The provision for the half-yearly settlement of the tax liability of weekly wage earners dates back to the tax year 1925-26. From 1916-17 to this date there was the provision for the quarterly payment of the tax by weekly wage earners. The connection between the first use of the quarterly assessments and the need for the more frequent settlement of the tax liability in the case of the small income is clear. The Report of the Royal Commission on the Income Tax made in 1920 contains the following explanation of the reason for the change:

Prior to 1916 weekly wage-earners were liable to assessment if their incomes exceeded the current exemption limit, and were chargeable in the same way as other employees, but the administrative difficulties in the way of assessing on a three year average men who continually changed their employers, moved about from place to place, and were subject to recurring spells of unemployment, were very great.

The rise in wages during the war and the reduction of the exemption limit from £160 to £130 in 1915, brought a large number of weekly wage-earners within the scope of the Income Tax for the first time, and the question how they were to be assessed became immediately a very practical one. It was felt that to charge them on a three years' average and to collect duty annually in one sum was impossible. The payment of any sum annually was quite outside the range of their ordinary habits and experience; they were paid by the week, and most of their disbursements were made weekly. Weekly assessments were admittedly impossible, and as a compromise it was arranged that they should be assessed quarterly.<sup>63</sup>

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<sup>63</sup> *Report of the Royal Commission on the Income Tax, op. cit.*, p. 107.

The reason for the change to the half-yearly assessment in 1925-26 is not so definite. However, by this time the post-war deflation had reduced wages and the exemptions were raised in 1920 by the granting of more generous allowances to married persons and for children. The result was the inclusion of fewer returns in the lower brackets thus reducing the number of returns to be handled and the pressure on the Department of Inland Revenue. This reduction in the difficulty of the job and the added experience in the administration of the Act with respect to the wage earner were undoubtedly the forces that made the change in the number of assessments take place without complaint. If it is possible for the wage earner to pay on the half-yearly basis and the administration does not find that there is a problem of evasion, there is, of course, considerable saving to the administration in the reduction of the number of assessments. Officials of the Inland Revenue advised the writer that the change has not worked any hardship on the income taxpayer and that the saving in administrative expense and bother has been considerable. They were not particularly concerned with the possibility of the loss of some tax from migratory labor that may have resulted from the change.

The attractiveness of the stamp method of settling the tax liability varies with the size of the exemptions and the trend of wages, as both factors determine how many persons will be included under the income tax at one time that are likely to have difficulty in meeting the infrequently assessed tax. During the war, with the low exemptions and the high tax rates that prevailed, there was extensive use of stamps. In answer to a question before the Royal Commission of 1920, the Chief Inspector of Taxes stated that in eleven months between December 1917 and November 1918, £867,000 was paid in stamps <sup>64</sup> More recently there has been a drop in the frequency with which the stamps have been used. The following letter from Mr. A. L. Beck of the Statistics and Intelligence Division of the Inland Revenue is the best source of information available at the present time. He states:

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<sup>64</sup> Statement of Sir Thomas Collins before the Royal Commission on the Income Tax, Minutes of Evidence, *op. cit.*, #695.

I have managed to obtain more information on the above matter, covering the past 10 years, and it seems that the amount of tax paid annually by means of stamps on cards was about £100,000 before the reduction of the exemption limit and personal allowances in 1931-32, and rose to £500,000 a year after that reduction. (These amounts are for the United Kingdom, i.e., England and Wales, Scotland and Northern Ireland.) It is too early yet to say whether the recent increase in the personal allowances to Married Persons, and for Children will lead to any diminution in the use of Income Tax stamps, as the 1st Half-Year's tax is only now being paid and the 2nd Half-Year is not due until July next. It may be of course that once the taxpayer has contracted the habit of paying his tax by weekly instalments—as that is what the stamp card method represents—he will never revert to the method of paying the tax in a lump sum to the Collector although the amount due may be much less than it used to be.<sup>65</sup>

It is of particular interest to note that although there is extensive use of collection at the source, there has been little use of this method for the collection of the income tax from the wage earner.<sup>66</sup> As was suggested above, it may be that this is for other than administrative reasons, such as the attitude of the trade unions. However, the administration has not felt that it was a point worth fighting for and seems to be content to leave well enough alone.

Another feature of the British law is that after the tax liability is determined by the administration and the taxpayer is informed of his obligation, a separate office with a specially appointed Collector is responsible for the final collection of the tax due. If a dispute is raised, the taxpayer goes to the office of assessment, but if there is no question of the amount that is due the Collector begins action in the courts. The basis of this separation of assessment from collection is legal and administrative. Special administrative problems arise because of the use of the separate schedules of assessment. Thus it is possible for separate offices to assess income from different sources if

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<sup>65</sup> Letter of March 3, 1937 to the author.

<sup>66</sup> In certain cases of public corporations, collection at the source has been used. For example, the employees of the London County Council are taxed in this manner.

they arise in different localities. The Collector, however, will be responsible for only the taxpayers in his district. Mr. E. Atkinson, Inspector for the Waterloo District, London, suggested that although it was not very important, he believed the separation added to the efficiency of his office and that it relieved him personally of the responsibility of seeing to the collection and that he felt that he was freer to make his assessments wisely as a result.<sup>67</sup>

Although special points about the British law as it affects the small income are of interest, it is believed that the really important lessons to be learned from the British are in the field of the actual administration of the law. Perhaps the most important features of the British administration are decentralization, high quality of the personnel, and the less tangible quality of an equal sense of responsibility to the people or taxpayers and to the government which imposes the law. Although these qualities are noted separately, they are closely connected and it is believed that there would be slight chance, for example, of maintaining the degree of decentralization practiced in Britain without first developing the personnel to the point where it could be given the responsibility that is involved with the assurance of its being able to do the job required equitably and without great inefficiency.

Although the British income tax is administered by a central board known as the Board of Inland Revenue, it is the local agent of this board known as the Inspector of Taxes who is the key man in the administration, especially of the income tax on the weekly wage earner. For each of the 725 income tax districts into which Great Britain is divided, there is a local Inspector of Taxes in charge of the assessment of the taxpayers in his district. If the district is large there may be one or two assistant Inspectors and a large clerical staff to assist in the assessment of the taxpayers in this district. It is this Inspector who is the person, or his office the place, where the great majority of the taxpayers are assessed and must go first if there is a question about the final determination of their proper tax

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<sup>67</sup> It probably also reduces the opportunity for graft.

liability. To the majority of taxpayers, the Inspector's office is the only part of the administrative machinery that they know, other than the Collector's office, and in most cases there is never any occasion for the taxpayer to look any further into the administrative organization.

The work of the Inspector demands a complete understanding of the law and the equally important qualities of administrative capacity and a sense of justice combined in the one man. After talking with many persons in the British administration and others familiar with it, the writer believes that these qualities are to be found in the local Inspectors of Taxes. The question arises as to how these virtues can be attained in public servants. Although it is suggested by some persons that this sort of thing is possible in Great Britain because the British are natural administrators and are in other ways naturally endowed with a superior capacity for government, much more important facts of a tangible nature provide the explanation to the person who is familiar with the British system.

In the first place the men who are to be future Inspectors of Taxes are carefully selected and trained for the job and given reason to believe that the job is one that offers a future comparable to that open to any of their equally superior fellows. Competitive examinations are required for entrance to the preliminary stages of the service, and thorough training in the law, accounting, and other phases of the work is given for a period after entrance. After this period of training of about five years as a cadet, further examinations are required before a man can qualify as an Inspector. Once given a district, the Inspector does not feel that he is as far as he can go, as there are open to the regular civil servants positions as Principal Inspectors, who are specialists in certain parts of the law, or in supervisory work or inspectorships in the more important districts where the nature of the work requires that there should be especially well qualified men in the post. At the top of the staff of Inspectors is the Chief Inspector appointed from the ranks according to merit. It is even possible that a man from the ranks will be appointed to the topmost post in the service, that of a member of the Board of Inland Revenue, which is

directly responsible to the government through the Chancellor of the Exchequer. Political considerations do not enter into the selection of the men and the pay in the service is comparable to that which might be obtained in work of a similar nature in private employment. Should an equally intelligent attitude toward the selection, training, and provision of opportunity for the men be taken in the United States revenue service, it is believed that after a few years, the plea that the English were endowed by nature with administrative ability could be disproved by the remarkable improvement in the caliber and capacity of the men that would result from the understanding of what is necessary for the solution of the real problem of personnel.

The second important way which the British have of assuring that the local Inspector will do his part in a fashion that is reasonable and in accordance with the sense of justice of the community is the placing of an unpaid body of local citizens over him. This body is known as the General Commissioners and is appointed by the Land Tax Commissioners.<sup>68</sup> The actual duties of this body of unpaid General Commissioners, which is responsible for a single district or a few neighboring districts, are not what are required by law as, in fact, the Inspectors have taken over many of the functions that were assigned in the law to the Commissioners. Although it is the legal duty of the Inspector to assess the weekly wage earner, it is the General Commissioners who are legally responsible for most of the other assessments which, in fact, are also made by the local Inspector of Taxes. In practice the General Commissioners are quasi-judicial bodies who hear and determine appeals from assessments made by the Inspector. It is not even true that they hear a large number of the original appeals as most of the protests of the taxpayer are settled between the taxpayer and the Inspector without there arising a dispute which calls for the intervention of a third party.

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<sup>68</sup> The basis of appointment is not clear. Spaulding states: "How the Land Tax Commissioners are nominated is a matter of mystery. The 1920 Royal Commission made an effort to fathom this mystery, but with no great success." (Spaulding, H. B., *op. cit.*, p. 248.)

However, regardless of the actual duties of the General Commissioners they have an excellent influence on both the taxpayer and the Inspector. The taxpayer feels that his interests are being protected by one of his fellow sufferers and the Inspector feels that if he becomes arbitrary in the determination of the tax liability the General Commissioners will laugh him out of court, maintaining the interest of the taxpayer against anything that is to them an unreasonable exercise of the power of the Inspector.

As the work of the General Commissioners often involves the hearing of cases where there are complicated legal and accounting points involved, and they are not required to have any qualifications in these lines, they are given the right to appoint a paid clerk to assist them in their work. This clerk is usually an accountant or a lawyer and will not only take care of many of the routine duties of the General Commissioners but also advise them on technical points of the cases being brought before them. The clerk is not necessarily a full-time employee and may at the same time he is serving the General Commissioners maintain his own practice.

The practical importance of these General Commissioners in the determination of the tax paid on small incomes is greatest in the influence they have on the Inspector, as there are few cases in the lower brackets that are taken before them. Although the Inspector is trained to realize the value of settling a case without forcing an appeal and is given authority to do this, he can never get far off the track without the possibility of an immediate check of an adverse decision on the part of the General Commissioners. The effect on the taxpayer is likewise of a desirable nature. If there is an unreasonable attitude shown by the taxpayer he will often be shown the error of his ways by the General Commissioners before there is the costly and time-consuming appeal to a formal court.

Much of the success of the function of the General Commissioners depends on the type of men selected and the responsibility they take for their job. As far as it is possible to determine, the General Commissioners fulfill their duties remarkably well and are respected by both the taxpayers and the administration.



Parish—MARSH.

No.....

To Mr _____
_____
_____

# INCOME TAX.

[HALF-YEARLY ASSESSMENTS.]

YEAR 1936-37.

In order that you may obtain all the Reliefs to which you are entitled in respect of **Personal Allowance, Children, Life Insurance, &c** (see list on enclosed sheet) you should fill up pages 2, 3 and 4 of this form and return it to me, duly signed, **WITHIN TWENTY-ONE DAYS** from this date.

If you wish for information or advice on any point, I shall be glad to furnish it

E. ATKINSON, H M Inspector of Taxes,

(Waterloo District),

5th Floor, Cornwall House, Stamford Street, S.E.1.

..... Date

**NOTE.**—If you make an annual return for Income Tax purposes on a different form, or if you have already completed a form similar to this for the above mentioned year, it is not necessary to complete this form, but the following particulars should be given —

Address of H M Inspector of Taxes }  
to whom return made }

\*Business Address }  
\*Private Address } from which return made }

..... Signature.

\*Delete as necessary

..... 193

The penalty for fraudulently concealing or untruefully declaring any particulars in making any claim for any allowance or deduction is 20 and treble the tax chargeable in respect of all the sources of income

If any person, for the purpose of obtaining any allowance reduction rebate, or repayment in respect of Income Tax, either for himself or for any other person, or in any return made with reference to Income Tax, knowingly makes any false statement or false representation, he is liable, on summary conviction, to imprisonment for a term not exceeding six months with hard labour

H 1.

(2048) Wt. 1205/1102 1,007,700 (118 parts.) 8/56 Hw G 646

[PLEASE TURN OVER.]



**NOTE.**—Your income from Wages has been returned by your employer amounting to £ : . for the half-year ending 5 October.

The declaration in Section G, at the foot of page 3, must be completed.

A		STATEMENT OF INCOME FROM EVERY SOURCE				
The full wages, including all overtime, bonuses, &c., should be stated.	INCOME FROM WAGES For whole of Half-Year ending— 5 October, 1936	Wages.			Particulars of Expenses (if any) incurred Half-Year exclusively for the purposes of payment, and claimed as a deduction from gross income. [See Note 10 on enclosure]	£
		£	s	d		
State from whom receivable	Income from any Pension receivable by you, other than a Wounds Disablement or Disability Pension (Full year's income to be stated. If none, write "None") —					£
Give the address of each property and the yearly rent; and include the annual value of the house you occupy if it is owned by yourself or your wife	Income from any Property you own (Full year's income to be stated. If none, write "None") —					£
State the names of the companies or societies, or other particulars of the investments Where the dividend or interest is received "less tax" or "free of tax," you should state so	Income you receive from any Dividends, or from Interest on War Loan, Funding Loan, Victory Bonds, or Bank (including Savings Bank) Accounts or Deposits, or from other Interest (The accumulated interest on National Savings Certificates is not taxable and should not be included. Interest from Industrial and Provident Societies (including Co-operative Societies) on mortgages, loans deposits or share capital should be included but not Dividends on Purchases) — (Full year's income to be stated. If none, write "None") —					£
Describe each source of the income. If any income from employment entered here, state period to which the figure relates and name and address of employer.	Any income not entered elsewhere on this page. (Full year's income to be stated. If none, write "None") —					£
	Wife's income, if not included above. (If none, write "None") —					£
Enter gross amount payable in the year.	CHARGES:—(Full year's charges to be entered. If you do not pay any Ground Rent or Interest on Mortgages or Loans, write the word "None")					£
	Ground Rent on —					
	" " " —					
	" " " —					
	" " " —					
	Interest on Mortgage or Loan —					
	£ — at — per cent. on — from —					
	£ — at — per cent. on — from —					
	£ — at — per cent. on — from —					
	£ — at — per cent. on — from —					

Page 3.

**B RELIEF TO A MARRIED MAN in respect of his wife.**

[See Note 3 on enclosed sheet.

If you are a married man and your wife is living with you or is wholly maintained by you, state here the full Christian names of your wife

Full Christian names of wife.

**C RELIEF TO A WIDOWER OR WIDOW in respect of female relative resident with him or her, or in respect of other female person employed, for the purpose stated below**

[See Note 4 on enclosed sheet.

Name of female relative resident with you, or of other female person employed by you, and for the purpose of having the charge and care of any child or dependent child of whom the deduction for children is allowed, or in the capacity of a housekeeper

Whether she is "married," "widow," or "spinster" (if married, but living apart from her husband, state so)

Relationship (if any) to you or to any deceased wife (or husband) if no relative is available, state so

Surname.

Full Christian Names.

**D RELIEF TO AN UNMARRIED PERSON in respect of mother or other female relative maintained by and living with the claimant for the purpose stated below.**

[See Note 5 on enclosed sheet.

Name of mother or other female relative living with and maintained by you, for the purpose of having the charge and care of any brother or sister of mine in respect of whom the deduction for children or adopted children is allowed.

Whether she is "married," "widow," or "spinster" (if married, but living apart from her husband, state so)

Relationship to you.

Whether any other relative contributes to the maintenance.

Surname.

Full Christian Names.

**E RELIEF in respect of (1) DEPENDENT RELATIVES maintained by the claimant or (II) DAUGHTER upon whose services the claimant is compelled to depend by reason of old age or infirmity**

[See Note 7 on enclosed sheet.

**(1.) CLAIM IN RESPECT OF RELATIVE.**

Name of relative maintained at any own expense and not himself or herself, or name of widowed mother maintained at any own expense

Relationship to claimant (if my wife or husband, state so; if widowed mother, state so)

Date of Birth.

Annual income of relative from all sources, including scholarship allowance.

Nature of disability, if any

Where now residing.

Whether any other relative contributes to the maintenance.

Surname.

Full Christian Names.

Day

Month

Year

£

# ADMINISTRATIVE ASPECTS

## (II.) CLAIM IN RESPECT OF DAUGHTER.

Name of daughter maintained by me and upon whose services I am compelled to depend by reason of old age or infirmity.		Whether she is "married," "widowed," or "single" (allow and deduct from her husband, state, etc.)		If you depend on her services on account of old age, state age.		Infirmary, state nature of infirmity.	
Surnames.		Full Christian Names.					

**F** (4) Give here a list of any **PREMIUMS** for **INSURANCE ON THE LIFE OF YOURSELF OR YOUR WIFE**.  
[See Note 9 on enclosed sheet.]

Name of the Insurance Company.	Total Premiums paid or payable for year ending 31st April, 1937	State whether on life of "self" or "wife"	Capital sum payable at death—excluding bonus or any other attached benefit.
1	£ 1	4	
2	£ 1	4	
3	£ 1	4	
4	£ 1	4	
5	£ 1	4	
6	£ 1	4	
7	£ 1	4	
8	£ 1	4	
9	£ 1	4	
10	£ 1	4	
11	£ 1	4	
12	£ 1	4	
13	£ 1	4	
14	£ 1	4	
15	£ 1	4	
16	£ 1	4	
17	£ 1	4	
18	£ 1	4	
19	£ 1	4	
20	£ 1	4	
21	£ 1	4	
22	£ 1	4	
23	£ 1	4	
24	£ 1	4	
25	£ 1	4	
26	£ 1	4	
27	£ 1	4	
28	£ 1	4	
29	£ 1	4	
30	£ 1	4	
31	£ 1	4	
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67	£ 1	4	
68	£ 1	4	
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92	£ 1	4	
93	£ 1	4	
94	£ 1	4	
95	£ 1	4	
96	£ 1	4	
97	£ 1	4	
98	£ 1	4	
99	£ 1	4	
100	£ 1	4	

(44) If you contribute to a Trade Union or Friendly Society, and any portion of your contributions is for **DEATH OR SUPERANNUATION BENEFITS**, give the following particulars —

Name of Trade Union or Friendly Society.	Full Contribution for last year	Portion for Death and Superannuation benefits.
1	£ 1	4
2	£ 1	4
3	£ 1	4
4	£ 1	4
5	£ 1	4
6	£ 1	4
7	£ 1	4
8	£ 1	4
9	£ 1	4
10	£ 1	4
11	£ 1	4
12	£ 1	4
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92	£ 1	4
93	£ 1	4
94	£ 1	4
95	£ 1	4
96	£ 1	4
97	£ 1	4
98	£ 1	4
99	£ 1	4
100	£ 1	4

If you claim relief in respect of **CHILDREN** or **ADOPTED CHILDREN** you should fill up **Section H** on page 4. Attention is also directed to **Section J** on that page.

**G** **DECLARATION (TO BE COMPLETED IN ALL CASES).**

I declare that all the particulars given by me on this form are correctly stated to the best of my knowledge and belief.

Signature (in full) .....  
 Description of Employment .....  
 Private address .....  
 Date .....  
 (A woman should state after her signature whether married, widow or spinster.)

If you have any **CHILDREN**, step-children or adopted children who are living and under the age of 16 years at any time within the year ending 5 April, 1987, or who, if over that age on 6 April, 1986, are receiving full-time instruction at any college, school or other educational establishment—give the following particulars [See Note 6 on enclosed sheet.

No relief is due in respect of any child who has income or earnings above £60 a year (excluding any income from a scholarship or bursary).

If any child is a step-child, write "step-child" below the name of the child

[illegible]

If you have any **INCOME OTHER THAN EARNINGS** and either you were, or your wife living with you was, 65 years of age or more on 6 April, 1936, give the following particulars —

	Day	Month	Year
Date of birth, if you were 65 years of age or more on 6 April, 1936 or Date of birth of your wife living with you, if she was 65 years of age or more on 6 April, 1936			

## LIST OF RELIEFS THAT MAY BE CLAIMED BY FILLING UP THE ACCOMPANYING FORM.

Relief from tax may be claimed by individuals on the following amounts of net income after deducting any annual charges such as ground rent and interest on mortgages or loans:—

(1) On one-fifth of the net wages as earned income allowance, subject to a maximum allowance (in the case of big earned incomes) of tax on £300.

(2) On one-fifth of the net amount of any income other than earnings, where the total income from all sources does not exceed £500, and either the taxpayer, or his wife living with him, was 65 years of age or more on 6 April, 1936.\*

(3) On £100, or, in the case of a married man whose wife is living with him, on £180 as a Personal Allowance for the year†. Where the income is wholly earned, these allowances, added to the allowance on one-fifth explained in Note (1) above, give relief on £125 and £225 respectively. [Where a married man's total income includes any earned income of his wife, an additional allowance may be claimed on four-fifths of the amount of the earned income of the wife, subject to a maximum additional allowance of tax on £45 for the year.]

Where, however, the total income from all sources does not exceed £125, exemption from tax will be allowed, and where the total income exceeds £125 but is less than £140 the tax payable on the total income will be reduced, where necessary, so as not to exceed one-fifth of the amount by which the total income exceeds £125.

(4) On £50 for the year to (i) a widower who has a female relative‡ of his or of his deceased wife resident with him (a) for the purpose of having the charge and care of any child or adopted child of his in respect of whom the deduction for children [see Note (6)] is allowed, or (b) in the capacity of a housekeeper, or (ii) a widow who has a female relative of hers or of her deceased husband resident with her for the purpose§.

If the widower or widow proves that he or she has no such female relative who is able and willing to take such charge or act in such capacity, the same allowance may be claimed in respect of some other female person employed for the purpose.

(5) On £50 for the year to an unmarried person who has living with him and maintains at his own expense either his mother (being a widow or living apart from her husband), or some other female relative, for the purpose of having the charge and care of any brother or sister of his in respect of whom the deduction for children or adopted children [see Note (6)] is allowed §. (A female taxpayer may claim in respect of either her mother or a female relative in the circumstances set out.)

(6) On £60 for the year in respect of each child, step-child or adopted child who is living and under the age of 16 years at any time within the year ending 5 April, 1937, or who, if over that age on 6 April, 1936, is receiving full-time instruction at any college, school or other educational establishment. ("Adopted child" means, for this purpose, a child of whom the taxpayer has the custody and whom he or she maintains)§.

No relief can, however, be given in respect of any child or adopted child who has income or earnings above £60 a year (excluding any income from a scholarship or bursary).

\* † ‡ § See notes overleaf.

(P.T.O.)

(7) On £25 for the year in respect of any person whom the taxpayer maintains at his own expense, and who is (i) a relative, of his, or of his wife, and incapacitated by old age or infirmity from maintaining himself or herself, or (ii) his or his wife's widowed mother, whether incapacitated or not, or (iii) his daughter who is resident with him and upon whose services he is compelled to depend by reason of old age or infirmity. (A female taxpayer may claim in respect of (i) a relative of hers or of her husband, or (ii) her or her husband's widowed mother, or (iii) her daughter, in the circumstances set out.)

No relief can, however, be given under (i) or (ii) if the dependent relative or widowed mother has income, excluding voluntary allowances, above £50 a year.

Where two or more persons jointly maintain a dependent relative as above, the relief from tax on £25 is to be divided between them according to the amount or value of the contributions made by each of the persons.

(8) Further relief is allowable equivalent to a reduction from the standard rate of tax of 4/9 in the £ to 1/7 in the £ on the net income, up to £135, not relieved from tax by the foregoing allowances.

(9) An allowance is also given, subject to certain restrictions, in respect of—

(i) Premiums paid for Insurance on the taxpayer's Life or on that of his wife (but not for Insurance on the life of any child or other person, or for any payment in respect of National Health or Unemployment Insurance)

(ii) So much of any Contributions to a Trade Union or Friendly Society as is for Death or Superannuation Benefits.

(iii) Compulsory contributions under the Widows' Orphans' and Old Age Contributory Pensions Act, 1925. (The allowance will be made without a claim.)

(10)¶ A deduction may be claimed for any payments on account of tools, explosives, and similar expenses incurred exclusively for the purposes of the employment.

\* Some allowance may also be due where the total income does not greatly exceed £500. Further information may be obtained from the Inspector of Taxes.

† The allowance of tax on £180 applies also, under certain conditions, in the case of a married man who proves that his wife, although not living with him, is wholly maintained by him.

‡ The expression "relative" in Notes 4, 5 and 7 includes any person of whom the individual had the custody and whom he or she maintained while that person was under the age of 16 years—that is, an adopted child.

§ The reliefs in respect of a female relative referred to in Notes 4 and 5, and in respect of an adopted child referred to in Note 6, are conditional upon proof being given that no other individual is entitled to any relief from income tax in respect of such female relative or adopted child, or, if any other individual is so entitled, that such individual has relinquished his or her claim to the relief.

¶ No deduction from wages is allowable in respect of the cost of travelling to and from the place of employment, or the additional cost of lodging away from home.

The sense of public service that this implies is hard for the average citizen of the United States to understand. It may be a point where the only explanation that is reasonable is in terms of the traditions of the English and where the reenactment of similar provisions in the United States would be doomed to failure.

In the execution of the income tax assessment in England there have been developed some interesting forms to assist in communications between the local Inspector of Taxes and the individual taxpayer. The number of detailed matters covered by these forms would almost make one think that there was never the necessity for the Inspector of Taxes to write an individual letter. After the returns from the local employers reporting the wages paid to their employees have been received and the other sources of information with respect to those in the district subject to the tax have been received, the local Inspector will send to these persons the preceding form and enclosure. (See Form 1.) This will be filled out by the taxpayer and returned to the Inspector's office for the computation of the tax liability. If return of income and requests for reliefs are not made out in a clear and satisfactory manner or there is some question as to the request for reliefs, the Inspector's office will send out individual forms to obtain the necessary information. An example of this type of form is presented here. (See Form 2.)

All the returns of income and requests for reliefs should be in the hands of the Inspector by the third week in May for wages received during the last half of the previous year. The notice of assessment for this period will go out between the first and tenth of July. At the same time as the taxpayer is notified of his tax liability, the Inspector will also notify the collector on a special form used for this purpose. A copy of the notice of assessment sent to the taxpayer is presented here. (See Form 3.) It should be noted that this still gives the taxpayer 21 days in which he may file a notice of objection. As similar procedure is followed for the wages and other income received in the first half year, the notice of assessment in this

case is sent out between the first and tenth of January of the following year.

In the internal administration there is equally impressive use of the printed form as a means of maintaining records and carrying on interdepartmental business. Although these forms cannot be reproduced due to their confidential nature, the author was given permission to inspect them and can attest their general usefulness in carrying on the activities of the administration. Registers of employers and employees are maintained where there is a continuous record at all times covering the past four years. It is the duty of the office which finds that one of its taxpayers has moved or changed employment in such a way as to make him liable to income tax in another district, to notify that district. In this way there is avoided some of the evasion that is bound to result from the migration of the wage earner.

The advantages of the British system of decentralization, with a coordinating central administration, are great. If a refined type of income tax is to be used in the lower brackets it would be impossible to think of its successful administration without some such scheme. Extensive decentralization permits the Inspector to become familiar with the district for which he is responsible and thus assures the minimum evasion, while the maintenance of the expert in the central office permits the development of a consistent policy and the convenient settlement of questions that are broader than the single district of the local Inspector. One point where the expert in the central office has proved himself particularly useful is in the determination of the amounts to be granted to the weekly wage earners in particular trades. With the existence of unions with membership including the whole of the British Isles the need for the uniform settlement is clear. It should be stated, however, that although there is little complaint about the administration of the income tax on the weekly wage earners and while it is believed that the maximum amount of fairness is achieved by virtue of the excellence of the work of the administrators and their reasonable attitude, the attitude of the administration is one of distinct coldness toward the extension of the principle to include a greater pro-

Parish .....  
(or Asst. Dist )

Sch. .... No. ....



File No.

## INCOME TAX.

Year ending 5 April, 1936.



### Allowance of Tax on One-fifth of Total Income.

If you are entitled to claim any allowance for the above year under the provisions set out below, you should complete page 2 of this form and return the form as soon as possible to

H.M. INSPECTOR OF TAXES,

#### PROVISIONS AS TO THE ALLOWANCE

A deduction may be claimed of Income Tax on one-fifth of the amount of the claimant's total income from all sources if he proves that at the commencement of the year of assessment either he or, in the case of a married man, his wife living with him was of the age of sixty-five years or upwards and that his total income for the year of assessment does not exceed £500.

Where, but for the fact that his total income exceeds £500, the claimant would be entitled to an allowance as aforesaid, he may claim to have the amount of the income tax payable in respect of his total income reduced, where necessary, so as not to exceed a sum equal to the aggregate of the two following amounts, that is to say, the amount of the tax which would have been payable if his total income had amounted to, but had not exceeded, £500, and one-half of the amount by which his total income exceeds £500.

Provided that where any deduction is made under this head no deduction in respect of the allowance for earned income can also be given.

No. 11—0.

\*M15892/1031 12/34 50 000(4) M&C(War) 638

[P T O]



Page 2.

(i) Name of claimant who was 65 years of age or more on 6 April, 1935, or (ii) in the case of a married man under 65 years of age, name of his wife living with him and 65 years of age or more on 6 April, 1935		Date of Birth
Surname 1.	Full Christian Names 2.	
		3.

I declare that the particulars given above are true and correct to the best of my knowledge and belief, and I claim the relief to which I am entitled by reason of the facts stated

\_\_\_\_\_  
Signature,

\_\_\_\_\_  
193

YEAR 1936-37.

Parish CHRISTCHURCH (C)



Asst No

# NOTICE OF ASSESSMENT TO INCOME TAX FOR THE HALF-YEAR ENDING 5 OCTOBER, 1936.

To Mr.

Office of H M Inspector of Taxes,

(WATERLOO DISTRICT).

5th Floor, CORNWALL HOUSE, STAMFORD STREET, S.E.1.

Office Hours—Daily, 10 a.m. to 4 p.m.  
Fridays, 10 a.m. to 7 p.m. (January only)  
Saturdays, 10 a.m. to 12 noon

## INSTRUCTIONS

**NOTICE OF OBJECTION.**—Any notice of objection to this assessment must be made by the Inspector of Taxes not later than 21 days after the date of service of this notice, and should be given either by calling on the Inspector at his office with this form on which the particulars in the space marked [C] overleaf and returning the form to the Inspector.

Where the Inspector is unable to make the alteration, the taxpayer is to appear before the Income Tax Commissioners, or before the Special Commissioners, and to appeal to them for the alteration. The taxpayer should inform the Inspector accordingly.

**PAYMENT.**—Where no objection is made, the tax payable hereon will become payable on January, 1937, to

Collector of Taxes, of

(LONDON 23rd COLLECTION)

4th Floor, 299/299, BROADWAY HIGH STREET, S.E.1.

whose Office Hours are as follows—

Daily, 10 a.m. to 4 p.m. Saturday, 10 a.m. to 12 noon.

The portion of this form marked [A] overleaf should be presented on paying him.

Where payment is made by post the taxpayer should insert his present address in the space provided on the back of this slip.

**MONEY ORDERS FREE OF COMMISSION.**—

A convenient method of payment is to obtain a Money Order in favour of the Commissioners of Inland Revenue for the amount due and send it to the Collector together with the portion of this form marked [A] overleaf. A Money Order may be obtained free of commission at any Money Order Office on production of this form.

An official printed receipt should be obtained for any payment of tax.

**WEEKLY PAYMENTS.**—Where the tax payable exceeds £100, an application being made to that effect, the tax may be spread over 12 weeks, on condition that Income Tax will be paid weekly in a special card which may be obtained from the Inspector. If you wish to adopt this method of payment, you should fill up the space marked [B] overleaf and send both the portion [A] and the portion [B] to the Collector by the date mentioned.

Date

TAKE NOTICE that you have been assessed on your Wages for the above Half-Year

as follows:—

Amount of Wages £ : s. : f.

Deductions allowed for the Half-Year:—

Personal Allowance £ : s. : f.

Household Expenses £ : s. : f.

Children £ : s. : f.

Dependent Relatives £ : s. : f.

Net Amount chargeable after above deductions £ : s. : f.

Tax thereon, \* at the rate of 1s. 7d. on £, and at 4s. 9d. on £ : £ : s. : f.

Less Half-Yearly allowance of tax on payments for Life Insurance £ : s. : f.

Old Age Contributory Pensions Act, 1925), and Contributions to Trade Unions and Friendly Societies for Death or Superannuation Benefits—£ : s. : f.

\* N.B.—The standard rate is 4s. 9d. in the £, but a reduction to 1s. 7d. in the £ is allowable on an amount of income not exceeding £155 for the year.

at 4s. 9d. in the £, but chargeable in your case at 1s. 7d. only—£ : s. : f.

at 3s. 2d. in the £

AMOUNT OF TAX PAYABLE FOR THE HALF-YEAR £ : s. : f.

\* N.B.—The standard rate is 4s. 9d. in the £, but a reduction to 1s. 7d. in the £ is allowable on an amount of income not exceeding £155 for the year.

H 13.

E. ATKINSON, H.M. Inspector of Taxes

Form 3. British Notice of Assessment to Income Tax

Page 2 *(With regard to)*

**A** Asst. No.

Purish }  
or }  
Place of } CHRISTCHURCH. (B).

Name  
Half-Year ending 5 October, 1936.  
Amount of Tax £  
PRESENT ADDRESS (to be inserted by the taxpayer):—

**(1)**

*For the use of the Collector.*

To the Collector of Taxes:  
Please supply me with a Card, in order that I may spread payment of this tax over 13 weeks under the new Purchase Income Tax Stamps weekly and to affix them to the Card

Signature \_\_\_\_\_ Date \_\_\_\_\_ 193

NOTE.—Portion **A** also of the form should be completed and sent when sending portion **B**.

**B**  
M 19  
H19 (000) W110511/1024 87% 396 600 (554 1936) JCASL:LD G45098

*This page, see the instructions printed overleaf/*

**C**

To H.M. Inspector of Taxes,

I hereby give you notice of my objection to this assessment.  
I claim that\*

Signature \_\_\_\_\_ Date \_\_\_\_\_ 193

Present Address \_\_\_\_\_

\*Give here full particulars of your objection, and of the correction asked for

Form 3 (continued)

portion of the lower income groups, and of doubt as to the practicability of the present level of exemption.

### The Taxation of Small Incomes in Australia <sup>69</sup>

In the Australian states in the depression years there have been very interesting developments in the direction of extending the state income taxes into the field of the lower brackets. Although the Commonwealth also imposes an income tax, the exemptions are relatively high (£250 plus allowances for wife and children) and the administrative techniques used are not so interesting as those found in the states.

The six Australian states <sup>70</sup> have all imposed an income tax on their citizens for some years. However, these taxes provided for exemption of amounts comparable in most cases to those granted in the United States; and, other than the interesting development of the granting of medical expenditures as a proper deduction and the administering of the Commonwealth tax by five of the states and the administering of the state tax by the Commonwealth in one case, there is little to be learned from these taxes regarding the problem of the direct taxation of small incomes. With the depression, however, there came an interesting development. This was the adoption by all the states of some new form of direct tax on the wage earner or a new low exemption income tax.

These new taxes may be divided into two types. One is the wage tax which is used by New South Wales, Queensland, and Western Australia, and may be characterized as a gross wage tax with exemption of wages below a definite level but with none of the deductions and allowances which are associated with

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<sup>69</sup> The writer is indebted to Professor Robert Murray Haig for much of the material presented in this section. Professor Haig has not only given the writer access to much of his own material not available in this country, but has also made available his notes on talks with many of the administrative officials in Australia made on the occasion of his recent trip to that country to study its tax system

Unless otherwise noted, the basic provisions of the law were obtained by reference to *The Law Book Company's Taxation Service*, Sydney, Australia, a service that sends out monthly memoranda to keep the subscriber posted on the changes in the law.

<sup>70</sup> New South Wales, Victoria, Queensland, South Australia, West Australia, and Tasmania.

the personal income tax. Although there may be differentials in rates giving a sort of progressivity and lessening the impact of the tax on the man at the margin, it is probably closer to the Social Security tax now charged the employees in the United States than it is to the true income tax. In New South Wales the tax is so crude that there is no provision for its adjustment in cases where the weekly wage is above the exemption limit (£2), and the tax therefore deducted, but the wage paid for only a few weeks. The result is that it is possible for the regular worker whose wage is just below the exemption limit to be free from tax, whereas another worker who is unemployed for a part of the year and receives a total income for the year of considerably less than the worker who is exempt may make a substantial payment. In these wage taxes there is, in all three cases, the requirement that the employer deduct the tax from the wage as paid, and in the cases where there is provision for rebates or other adjustment of the final tax liability he is also required to give the employee a receipt in the form of a stamp to be kept by the worker and placed in his wages book and presented at the time when claim is made for the rebate.

This type of tax as used in Australia is of interest in this study not as an example of the type of lower bracket income tax that might be profitably adopted in the United States, but as an example of the thing that might result from the plea for the more extensive taxation of the lower bracket income. Apparently there is not sufficient opposition to this sort of crude measure of taxable capacity to prevent its adoption and the tax officials feel that a more refined tax would be impossible to administer without excessive costs or extensive evasion. Another factor is that the purpose of the tax is usually to finance unemployment relief. Although there are, of course, high costs of compliance, there is no evidence that the employer has been especially annoyed. The advantages of this type of tax are believed to be that it is definite in the imposition of its burden regardless of the inequities of the eventual distribution, and that it is a good revenue producer with the minimum cost of collection. Other than these practical points, there is little that can be said in its favor.

In contrast with the crude measure of taxable capacity used in the states mentioned above, the states of South Australia and Victoria have found it possible to lower the level of the exemptions under the income tax and still maintain the advantages of the more refined type of personal income tax as used in the upper bracket income tax. In Victoria the tax is known as the Unemployment Relief Tax and provides for a basic exemption of only £105 for single persons and £175 for married persons. In South Australia the regular income tax exemptions were lowered to a basic exemption of £100 and £30 for wife and also £30 for each child. In both cases the income is assessed on a yearly basis and full allowance is made for the normal deductions of the personal income tax. All income from all sources is included in the final assessment.

In the administration of these taxes there has been developed a novel variation on the usual deduction at the source. This unique system of administration grew out of the difficulty with which the government of South Australia administered the income tax after the rates were raised to new high levels in 1930. It was found in South Australia that there were many wage earners who were not able to pay the tax due in one lump sum, and the administration was therefore forced to accept payments by installments. As the tax was continued there was developed a system whereby the employees of an establishment could band together in a group and pay the tax in installments through a representative. As this use of the group scheme proved to be a success, the Commissioner of Taxation worked out a scheme whereby the employer could deduct a regular amount from the wages paid to the workers, remit this to the government, and then give to the worker a tax stamp of a value of the amount deducted from the wages. These stamps are held by the workers until the amount of the deductions as represented by the stamps is sufficient to meet the tax assessment for the year. If there are not sufficient stamps to meet the assessment when it is due, the balance is payable in cash or, if the value of the stamps proves to be too great on the final determination of the total liability after full allowance is made for the proper deductions, the government makes the necessary adjustment on

the presentation of the stamps with the final assessment. To prevent unnecessary deductions and rebates of stamps, the worker can get a certificate of exemption from the tax authorities which may be presented to the employer to authorize him to pay the wages in full. The granting of a certificate of exemption is carefully checked and if the employee has any tax due from previous years it may be collected by the refusal of the certificate. Before a certificate is granted, there is also a check made on the taxpayer's record of the previous five years and in this way it is possible to collect tax from defaulters of previous years. This check is so thorough that it is reported that there are taxpayers who permit the deduction to be made and will sell the unnecessary stamps at a discount to avoid the charge and penalty of past evasion.

The success of the plan is attested by two students of the operation of the tax who are fully familiar with the Australian situation. Professor Hytten of the University of Tasmania makes the following comment:

Experience so far seems to show that the scheme is an unqualified success. Its success in providing a more regular flow of revenue may be measured by the fact that on April 30 this year 85 per cent of the estimated total yield of the income tax had been collected, as compared with a collection of 67 per cent at the same date in 1931. The reason is that all employees and a great many other taxpayers commence their payments right at the beginning of the financial year, and will in many cases have paid their full tax by the time they get their assessments. There is a definite benefit to the Treasury in this early revenue, in that it helps save interest on overdrafts, and it is particularly welcome at a time when bankers are viewing Government overdrafts with growing disfavor.

The scheme has shown another rather unexpected advantage to the Treasury in that it has stopped a great deal of evasion. This arises from the necessity for employees to obtain a certificate of exemption from the taxation department as an alternative to the automatic deduction of a shilling in the pound. Whenever an employee seeks such a certificate the department carefully checks his past returns, and in numbers of cases it has found that a person has failed to submit returns for years past. . . . The scheme is still in its infancy, but the general feeling in South Australia is one

of satisfaction, on the part of both the Government and the taxpayers. It suits the majority of taxpayers, who find a difficulty in paying the heavy tax in one lump sum at 30 days notice, which owing to the frailty of human nature, always seems far too short.<sup>71</sup>

A representative of the Taxpayers' Association seemed to be equally enthusiastic about the merits of the South Australian scheme. He stated in his presentation of evidence before the recent Royal Commission on Taxation that,

In respect of wages and salaries we favor the system inaugurated by South Australia and subsequently adopted by Victoria. . . . The reason we say we support this scheme is that we think that it has the advantage that it does put a net around taxpayers that might otherwise escape, but at the same time it leaves the system of deductions of concessional allowances.<sup>72</sup>

In Victoria a scheme practically identical with that found in South Australia has been adopted as the result of the failure of a stamp duty on wages collected at the source for the purposes of unemployment relief. At the time of the hearings before the Royal Commission, the tax had not been in effect long enough to test its reliability but its record in recent years has been reassuring. One protest was raised against the newer levy on the ground that it might become a stepping stone to the undesirable gross income tax in the event that the administration proved to be too difficult or the costs of collection too high. The number of rebates that are necessary under either of these two schemes is, of course, at best rather large, and will doubtless increase the cost of administration by a considerable amount over that which might be expected with the use of the gross tax. Another objection to the new tax, raised on the theoretical consideration of the question without basis in practical experience, was that the large number of overpayments would be hard on the taxpayer. This objection seems to be met, in part, by the

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<sup>71</sup> Hytten, T, "Collecting Income Tax at the Source," *The Economic Record*, Vol. VIII, No. 15, December 1932, pp 278-281.

<sup>72</sup> Evidence of Clifford H. Browne, Accountant testifying for the Taxpayer's Association of South Australia, *Report of Proceedings of the Royal Commission on Taxation*, Commonwealth of Australia, 1934 (mimeographed), pp 2898-2899.



statement of the South Australian administration that the workers in that state use the income tax books for the purpose of a savings bank. Although this will increase the number of rebates that will be made, it would seem to indicate that this point can be exaggerated.

Lack of familiarity with the details of the administration and of a thorough understanding of the environment in which these novel income taxes are used prevents the forming of any positive conclusions as to their merit. This is particularly true if it is desired to appraise the usefulness of similar schemes in the United States. What is natural and very practical in one country may not work at all in another. It may be concluded, however, that the system worked out in South Australia with the payment on account of the income tax, collected from wages at the source, is worthy of special consideration. This scheme is of great usefulness, however, only in cases where there are regular wage payments to employees, as it is necessary to have the cooperation of the employer to give the real advantages of the system. There are still the problems of the determination of the tax liability of the independently engaged person in the lower brackets, particularly the farmer, and the prevention of evasion on the part of these people. To be sure that income of the wage earner, other than that received in the form of wages, is fully accounted for is still a problem that requires the best administration and the cooperation of the taxpayer. Possible difficulties also arise if the employer does not make full returns of wages. In New South Wales the field audits of the Wages Tax returns made by employers reveal from 25 per cent to 33 per cent of the employer returns contain some irregularities. Although our own employers have seemed to cooperate in the administration of the social security tax, it is possible that the addition of another set of records for them to keep would result in a worse reaction and the complete failure of a similar measure.

An interesting observation on the practicability of the Commonwealth's adoption of the source method of collection of the income tax from salaries and wages was made by the Federal Commissioner of Taxation. He said:

I do not favor the proposal now for Federal purposes (source tax of salaries and wages). I understand my views are held in some State taxation circles as the Federal scheme superimposed on the State scheme would prove extremely difficult in regard to adjustments.<sup>73</sup>

This is a point that should be carefully considered by the proponent of the direct taxation of small incomes in the United States, with the hope that there would result a great increase in the amount of tax consciousness. As has been suggested above, tax consciousness requires that there be a clear distinction maintained between the different levels of government, and if it is to be obtained by the use of the lower bracket income tax, requires that both the states and the federal government use this type of levy.

### The Taxation of Small Incomes in Germany

Since the development of the Prussian income tax in the latter part of the 19th century the personal income tax has been an important source of German tax revenue. One of the chief characteristics of the law is the extremely low level of the personal exemptions. The result has been to obtain a large part of the total revenue from the taxpayers in the lower brackets. In recent years incomes under 5,000 reichsmarks, or approximately \$2,000.00,<sup>74</sup> have yielded about 45 or 50 per cent of the total income tax revenue and about 10 per cent of the total German federal, state and local revenues.<sup>75</sup> Although there are certain difficulties in the interpretation of the present laws, the stress placed on the taxation of small incomes in Germany makes it desirable to include in this study whatever information is available.<sup>76</sup>

<sup>73</sup> Evidence of Robert Ewing, Federal Commissioner of Taxation, *Report of Proceedings of the Royal Commission on Taxation, op. cit.*, p. 4129.

<sup>74</sup> The value of the mark will be assumed to be 40 cents. Although this is the official exchange rate it is generally believed to be too high in terms of general purchasing power. The complexity of the current exchange controls and the uncertainty of internal price conditions in Germany make any assumption as to the proper conversion rate rather unsatisfactory.

<sup>75</sup> *Statistisches Jahrbuch für das Deutsche Reich*, Berlin, 1935, 1936, 1937, 1938.

<sup>76</sup> The writer is indebted to Georg Dobriner for assistance in the development of this section. Mr. Dobriner served in the German tax administration

The German personal income tax is levied on total net income.<sup>77</sup> The deductions from gross income include expenses necessary for the acquisition of the income and certain special expenditures, such as insurance premiums and payments to building and loan associations. The allowance of special expenditures, which until recently included such items as church taxes and outlays for female domestic help, is granted without proof up to an amount of 200 reichsmarks and beyond that amount up to an upper limit which varies with the family status of the taxpayer.<sup>78</sup>

After the computation of the net income there is granted the exemption of a minimum graduated according to the family status of the taxpayer.<sup>79</sup> This allowance has certain demographic connotations as the allowance for dependent children is greater for the third child than for the second and is still greater for the fourth and each succeeding child until the tenth. Additional relief may be granted in the form of a reduction of the tax liability if the taxpayer can prove "extraordinary economic conditions which considerably influence the taxpaying capacity of the person liable to taxation . . . if the income does not exceed 20,000 reichsmarks."<sup>80</sup>

The granting of relief for extraordinary economic conditions is at the discretion of the administration. Considered as extraordinary economic conditions are unusual burdens arising "through maintenance of children or needy relatives, even if they do not belong to the household of the person liable to taxation and through other necessary expenditures which do not belong to the special expenditures . . . , in particular, expenditures on account of sickness, death, or accident."<sup>80</sup>

Reference to Table V indicates the severity of the present level of exemptions. This is increased by the fact that, with

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for nine years. He is familiar with the assessment procedures and the interpretation of the law, having been trained and having served both in legal and administrative work.

<sup>77</sup> *German Income Tax Laws*, edited in the office of the general counsel for the Department of the Treasury, Washington, 1938, pp. 3-5. Hereafter cited as *German Income Tax Laws*.

<sup>78</sup> *German Income Tax Laws*, Article 10, pp. 7-8.

<sup>79</sup> *German Income Tax Laws*, Article 33, p. 16.

<sup>80</sup> *Ibid.*

the exception of children's wages, the income of husband, wife and minor children is considered as that of the family head and assessed as a single income. This results in the granting of the exemptions and allowance for special expenditures only once and the application of higher rates on a joint income than would be paid should they be reported separately.

TABLE V. INCOME TAX EXEMPTIONS AND ALLOWANCES FOR SPECIAL EXPENDITURES IN GERMANY \*

Family Status	General Exemption	Allowance for Special Expenditures	
		Minimum	Maximum
	(in reichsmarks)		
Single Persons.....	560	200	500
Married Persons:			
without children.....	825	200	800
with 1 minor child. ....	1125	200	1100
with 2 minor children.....	1425	200	1500
with 3 minor children .. .	1925	200	2100
with 4 minor children.....	2550	200	2900
with 5 minor children.....	3800	200	3900

\* Source: *German Income Tax Laws*, p. 27.

To assist in the collection of the income tax from persons engaged in nonindependent work there is a special wage tax collected at the source. Source collection is also used for certain types of capital incomes. The wage tax is applied to all wage incomes up to 8,000 reichsmarks and if the total income does not exceed this amount relieves the taxpayer from further liability. If the total income is over 8,000 reichsmarks, the amounts collected at the source are credited against the total tax liability.

To assist the employer in the determination of the wage tax a schedule has been prepared for his use computing the tax on the basis of gross wages paid. The wage tax exemptions include in lieu of the 200 reichsmark deduction for special expenditures and the allowance for extraordinary economic

conditions, a deduction of 468 reichsmarks a year or 39 reichsmarks a month. If the wage earner can prove that his status is such that he is entitled to more than this amount he can obtain the balance by application to the local tax office. The employer is further assisted by the preparation of schedules of the tax due on the basis of monthly, weekly, daily, and hourly wages. The official table is computed on the basis of a monthly wage but there are the other tables computed by the administration.

Until the depression of 1930, the wage earners were treated with every consideration shown other taxpayers. Although the rates were high, they were not out of reason if considered in comparison with the rest of the tax structure. However, with the development of a deflationary policy in the early 1930's it became popular to demand heavier taxation of the small income groups. This was backed by the statement that only in this way could the laborer, white collar worker, and small business man be made responsible citizens. In view of similar arguments advanced in this country it is interesting that the writer has been advised that rather than lead to better citizenship the net result was the ultimate loss of confidence of the masses in their post-war leadership. Particularly distressing to this group was the abolishment by decree in 1931 of all refunds of wage taxes overpaid during the year. The refunds were the normal consequence of the fact that the monthly or weekly wage from which taxes were deducted might not continue for the entire year and even might not be large enough to require the payment of any tax after the yearly allowances had been accounted for.

Although it is logical to believe that this inequitable treatment of the wage earner could be justified on administrative grounds, the writer has been informed that a more pressing reason was the desire to increase the government's revenues by approximately 66,000,000 reichsmarks, the amount of the rebates formerly granted to wage earners. Whether or not this sort of procedure is inevitable if the administration makes use of the rebate procedure cannot be proved by this one example. However, if this country follows the suggestion of those who would shift the tax burden from their own shoulders to those of the wage earner with the argument that this is the way of

a democracy, there is no telling what the eventual outcome of the policy may be. There is still a case for the proper sort of tax consciousness, but if used as a means of avoiding the proper distribution of the burden it may as well lead to Hitlerism as to the utopian democracy of the future.

Although the comparison of the German and American law is of interest it is the administrative techniques which the Germans have worked out that are most valuable to the student of American taxation of small incomes. In this connection, however, it should be remembered that the present German government is not comparable to that in a democracy and that even in the post-war republic the attitudes of the people and the type of public servant differed greatly from this country. Administrative institutions cannot be transplanted from one environment to another. However, basic rules of procedure are made more obvious by the study of the strength and weakness of other systems.

Seligman's comment on the administration of the successful Prussian income tax of 1891 is an indication of the degree to which differences of attitude may affect administrative procedure: He said: "In the second place, the administrative methods employed in Germany, and especially in Prussia, would be impracticable almost anywhere else. In no place is the bureaucracy so powerful. Nowhere else are the people so meek in the face of officialdom. In no other country of the world would it be possible to enforce so inquisitorial a procedure as we have learned to be customary in Prussia."<sup>81</sup> This comment might have been made today with equal force. Although it is probably too strong for the practices which prevailed under the republic there is little question that the old Prussian tradition had its influence on the procedures followed at that time.

One of the most interesting features of the old Prussian law which has been retained up to the present time is the practice of making a yearly census of the total population in order to ascertain all persons subject to taxation.<sup>82</sup> The municipal tax

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<sup>81</sup> Seligman, Edwin R. A., *The Income Tax* (2nd edition), New York, 1914, p. 271.

<sup>82</sup> *Ibid.*, p. 252.

administration conducts the census and gives a copy of it to the local federal tax offices. The information is kept up to date by the requirement that there be given to the local police a record of any transfer of residence, copies of which are sent to the municipal and to the local federal tax administrations.

The census is taken each year on the tenth of October by the municipal tax office. Shortly before this date a census form is issued to all landlords or landowners in the municipal district. The form requires the statement of the name, occupation, date of birth, and family status of all residents. If the tenant is a new resident, statement of the place of payment of the income tax the previous year is required. Servants and guests are included to avoid the possibility of omissions. Inquiry is also made into the conduct of business on the premises. Once the census is complete, it is used for the preparation of a list of natural persons, corporations, and business enterprises by the municipal tax office. This list is forwarded to the local federal tax offices and is then used by them as the determination of the taxable entities within each district.<sup>83</sup>

As far as the writer is able to tell this yearly census is a feature of the German administration not found in other countries. As detailed records of all residents have been maintained over a period of many years for military and police purposes, an additional listing for tax purposes does not strike the German as being unusual. However, if similar methods were tried in the United States or Great Britain the public might be expected to register a vigorous protest, even to the extent of discrediting the entire tax program.

Although an unusual feature, the yearly listing of all residents plays an important part in the administration of the tax on small incomes. Through this census is exercised the control of all recurrent taxation. It is especially useful as a means of checking whether or not every taxpayer has filed the returns due from him.

In the case of the assessed income tax, the procedure followed

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<sup>83</sup> For an example of the form used see: *Reichssteuerblatt*, 1924, Reichsfinanzministerium, Berlin, pp. 190-193. This form was in use as late as 1934 but there is no assurance that it has not been changed since that date.

is not out of the ordinary with the exception of the use of the census mentioned above. In the case of the wage tax, however, there is a procedure used which is worth describing in some detail. The first step in the assessment of the wage tax is the mailing, by the municipal office to all persons listed in the census as wage earners and subject to the wage tax, a tax card between the date of the census and the first of December. On this card is listed the name, profession, address, family status, and number of children of the taxpayer. Space is provided for the notation of changes in family status and for recording specially granted tax free amounts for special expenditures and extraordinary economic conditions. On the second page of the card there is space for the recording of wages paid and taxes deducted. On the third page are instructions to be followed by the employer and the employee, and on the fourth page is place for the recording of the municipal poll tax which is based on the wages received for the previous year.<sup>84</sup>

As the tax card is the basis for the collection of the wage tax, the recipient of the card must make the proper adjustments if he is to receive all allowances. As the census information takes care of the adjustment for family status it is the problem of the wage earner to see that his allowance for special expenditure and extraordinary economic conditions does not exceed the 468 reichsmarks a year allowed in the basic wage tax exemption. If the taxpayer can prove that he is entitled to additional allowance, he will make the proper application to the local branch of the federal tax office and if the additional amount is allowed, it will be entered on the tax card.

Determination of the proper amount to be granted for special expenditures or for extraordinary economic conditions does not present any special difficulty. However, there is a real question which arises when there is a claim for expenditures incurred in connection with employment. Such expenses are difficult to define and also difficult to check, as the borderline between personal living outlay and expenses of employment must always be rather vague. As is the case in Great Britain, the chief con-

<sup>84</sup> For the form of the tax card see: *Reichssteuerblatt*, 1931, Reichsfinanzministerium, Berlin, p. 805.



cern of the administration is in the equal treatment of employees in similar positions. However, in contrast to the British method of the establishment of general allowance for different groups by consultation with their trade union representatives, the German administration grants authority to the intermediate province administrative offices to establish general rules for different employment groups. In the case of large firms with employees living in many different local districts, the local office in the district in which the plant is located ascertains the basis for the general allowance and furnishes the tax office of the employee's residence with the necessary information. Again in contrast with the British procedure, the German administration is confronted with the problem of the determination of the proper allowance for a period when the income has not yet been earned and the expenses not yet incurred. In spite of the obvious difficulty of handling the large number of individual tax cards in the short period between the second half of December and the first of March, the writer is advised that little difficulty is encountered and relatively few cases are brought to administrative or judicial review. Applications for additional tax exemption may be filed at any time during the year with the limitation that no allowance will be granted for the period before the submission of the application.

After the necessary information has been gathered on the tax card and arranged in a manner that will tell the employer the exact amount that he is to deduct from each wage payment, the card is given to him and remains in his possession until the end of the year or the discharge of the employee. The employer is responsible to the federal administration for the regular remission of the amount collected from his employees and must submit to a regular audit of his books. In order to facilitate this audit, the employer is required to maintain a separate payroll account for each employee containing the full information given on the tax card, including the number and the issuing municipality. In the account are entered at the time of wage payment, the amount of the gross wage payment, the tax deducted, and the period for which these payments were made. The tax deducted by the employer has to be paid over to the

federal tax office on the fifth and twentieth of each month, except in the case of small concerns with no more than five employees which can settle their liability on a quarterly basis.

It is clear that the maintenance of such detailed records must involve the employer in considerable additional expense. Their apparent willingness to submit to the imposition of this additional burden is perhaps another indication of the fundamental difference in the attitude of the German business man. However, the relatively low cost of clerical help in Germany is a factor that may explain a part of the differences in attitude toward the assumption of burdens of this type.

If the wages consist wholly or partially of payments in kind and the wages paid in cash are not sufficient to pay the tax, the employee has to pay the employer the amount necessary to pay the wage tax. If the employee, in addition to current wages, receives other receipts from the same employment, such as dividends or bonuses, these receipts are taxed at special rates. For single employees the rate is 16 per cent, for a married couple without children, 10 per cent, if there is one child the rate becomes 8 per cent, for two children it is reduced to 6 per cent, for three children 3 per cent, and if there are four or more children the rate becomes 1 per cent. The reason for this special rate for unusual income or non-recurring income is that the Germans believe that true income must be of a continuous nature and therefore feel that, in special cases where there is no reason to believe that the return will continue in the future, the progressive rate schedule should not be applied.

Although the author is not certain of the type of administrative organization which is at present responsible for the assessment and collection of tax it is of interest to give a brief outline of that which prevailed before the rise of the Hitler regime. In general, it followed many of the principles that are characteristic of the British administration. Administrative authority was delegated in successive steps from the central authority down to a highly decentralized local administration which was the agency responsible for the greater part of the contact between the government and the taxpayer.

The central authority, or Reichsfinanzministerium, was made

directly responsible to the government by the fact that at its head was a member of the cabinet. It was divided into separate units for the purpose of guiding and supervising the administration of different federal taxes. It was also the chief policy-forming agency. Under the Reichsfinanzministerium there were in Germany proper 23 province administrative areas (Oberfinanzämter) or intermediate district offices. These province offices were responsible for the supervision of the assessments of the local offices, the formation of rules of assessment supplementary to those issued by the central office, the adaption of general policy to their particular areas, the conduct of formal audits except for national concerns, and the hearing of complaints and the passing of quasi-legal judgments on questions of fact and matters of the interpretation of the law. There was a special judicial branch of the province administration to handle these legal questions (Finanzgericht). The decisions were subject to appeal to an independent supreme court (Reichsfinanzhof) which heard only tax cases.

Each province was divided into many local administrative areas (Finanzämter) which were responsible for the actual process of assessment and semi-formal audit. The assessor who was in charge of a single case in the local office was granted considerable discretionary power but was subject to the supervision of his administrative superiors. To make this possible the assessor was not burdened with routine work and was always in close touch with the head of the office, exchanging opinions freely. A trained clerical staff was responsible for the actual preparation of the individual assessment and the assessor was concerned only with the doubtful cases or matters of the proper interpretation of the law.

In Berlin there were 35 Finanzämter for some 4,200,000 people. In each office there were from six to eight assessors. A senior assessor was in charge of the managerial duties of the office but took only nominal responsibility for the assessment in any individual case. Each assessor was assisted by six to eight clerks.

In an administration with the degree of delegation of authority to the local offices which characterized the German system,

its success is dependent on the ability of the government to obtain the proper type of official. Until recent years this was assured by the fact that there was real incentive to go into the tax administration and that careful training was required. Most of the candidates selected were law graduates who had served a three-year court clerkship and had acted for some time as a magistrate. Upon appointment the candidate was on trial for a period of a year and if this probationary period was passed successfully he was eligible for a life appointment in three years. In this case there was the opportunity to rise in the ranks to the highest position. Additional incentive was provided by the favorable salary schedule and the social prestige that was connected with the position. Even the clerical staff was selected to a considerable degree from well-educated men and was trained carefully in the administrative procedures. Incentive for this group was provided by the possibility of a few qualifying for an assessor's position with equal title, pay and rank. The great difficulty for this group is the fact that this position could only be attained after many years in the lower clerical position.

Although it is difficult to weigh such intangible factors, perhaps one of the important reasons for the type of administration developed in post-war Germany was the tendency for the German people to place the interests of the state above those of the individual. Certainly this must be a factor in the appeal that public service had and still has for the average German.

Another notable achievement of the German administration was its care in the development of public goodwill, at least until the financial difficulties of the depression brought about short-sighted modifications of the law in the interest of revenue. One of the chief means of developing the necessary goodwill was the maintaining of a sufficient number of local officers with long enough office hours to permit any taxpayer to seek advice from the proper official and have all complaints adequately heard.

In conclusion it should be stated that although there are many features of the German law and administration that commend themselves to the attention of the United States, it

would be foolish to suggest that a comparable tax law could either be enacted or enforced in this country at the present time.

### Conclusions

The administration of the direct tax on the small incomes has been found to present some very difficult problems. The assurance that there will not be considerable evasion is more difficult to maintain as the exemptions are lowered and the decision as to what is to be included in the definition of taxable income is found to be complicated by the fact that there would be included in this type of tax a new economic group unlike the present income taxpayers in the way in which their income is obtained. All evidence available seems to indicate that there would be a considerable increase in the cost of collection of the income tax should the exemptions be lowered. How great this increase would be is impossible to determine, but it may be said with some assurance that the lower the exemption the greater the cost, granting that there is maintained the full provision for exemptions and allowances.

These conclusions as to the nature of the problem suggest that special care be used in the development of administrative organizations for the collection of this type of tax and that the methods used by the organization be carefully considered before they are applied to the actual administration of the tax. The experience of the British is of special value in the lesson it teaches as to the value of the flexible decentralized administration and particularly as to the value of a well-trained and competent personnel. The Australian experience is equally valuable as it is most suggestive on the possibility of the development of special techniques to assist in the administration of a direct tax on the smaller income that is practical and at the same time equitable.

As far as the problem in the United States is concerned, the experience of the states with the lower exemptions indicates that there are special difficulties to be faced in the determination of the tax liability of the small income group in the farm states. This is particularly unfortunate as it is these states that have tried the lower bracket income tax more frequently than the

others. There are also the states that are in need of a practical method of administration of this type of tax due to the low average level of their citizens' incomes.

The main conclusions that can be reached are that administrative difficulties of the direct taxation of the small income in the United States are considerable and that the "go slow" sign is posted at all crossings. The adoption of the tax by the federal government would create a particularly difficult problem as the varying conditions in the different economic areas of the country would prevent the adoption of a simple administrative technique. On the other hand, the federal government would probably find that the development of adequate personnel would be easier than in the states. In any event, it may be concluded that there should be a period of preparation before either a state or the federal government makes a drastic revision in the existing level of their exemptions. Careful preparation for and anticipation of the greatest possible number of the special administrative problems that can be made would be the only way in which there would be even a fair chance of the successful administration of a levy of this type.

## CHAPTER 7

### CONCLUSIONS

It is not the purpose of this study to present detailed recommendations as to what should be done about the direct taxation of small incomes. In conclusion it will suffice to summarize certain results of the analysis which may serve to give to the makers of policy a broader basis for the drawing of conclusions as to the desirability of the suggested modification of the tax system.

Some of the conclusions of the body of the study are favorable to the increased use of the direct tax on small incomes, provided the burden now imposed by the various indirect levies is reduced or removed, or if there is a general increase in the total tax burden. On the other hand, many of the results hoped for would be at best rather uncertain of achievement by the action suggested. In striking a balance, the weight assigned to the different factors will naturally vary with the different values attached to various objectives by the appraiser. The paragraphs that follow present the favorable factors and the unfavorable factors in summary fashion, in the hope that all points receive the consideration that is due. This is particularly important since the popular consideration of the issue has been notably superficial and lacking in appreciation of the complex nature of the issues involved.

In the first place, the study shows that the fiscal productivity of the proposed step, while commonly exaggerated, would be very substantial. It is one way in which more money can be collected by the public fisc. Many people seem to feel that, if there is to be an increase in the aggregate amount collected in taxes, it will have to be obtained from some entirely new type of tax. This belief is based on the dissatisfaction with present taxes and the feeling that the chances of obtaining the necessary cooperation are better with a new type than with an old.

Although this is illogical as a simple statement of fact, there is probably some psychological basis for the belief that although there is only one well to be drained, it can be done more thoroughly with two shafts than with one. However, it is clear that the facilities of the income tax shaft have not been fully utilized.

On the basis of the assumption that there would be a cut in the level of the exemptions under the federal income tax by one-half, perhaps the greatest reduction that could reasonably be urged at the present time, the total increase in the federal receipts would range from \$200,000,000 to \$500,000,000. As the federal deficits are still in the billion dollar range, the hope that the budget could be balanced by the simple expedient of lowering exemptions is unfounded. Moreover a large part of the increase in the yield of the income tax as estimated above arises from increased taxes paid by persons already subject to the levy. The increase attributable solely to the direct taxation of incomes below the present level of exemptions would be less than half as much.

The maintenance of the proper distribution of the tax burden is generally believed to be of importance second only to fiscal productivity. Although there is not complete agreement as to the desirable pattern of distributing the tax burden, it is believed that the use of the income tax in the lower brackets affords an opportunity to attain whatever type of distribution of the burden that is desired by the great majority of the people in this country. It permits the definite determination of the extent of the tax burden imposed in any case and makes possible the granting of such special allowances as may be believed to be desirable. If one believes, as does this writer, that the principle of progression should be effective throughout the tax structure, in general, except insofar as benefit levies are available and acceptable, the use of the income tax as an alternative to the present indirect taxes is the only way of attaining this goal and at the same time obtaining the necessary revenue. If one believes that the very smallest income recipients should be relieved from any tax burden at all, it is practically impossible to assure this with the maintenance of any extensive use of the indirect taxes in common use today. It becomes necessary to use the



direct tax on small incomes, which permits the exemption of income recipients below any specified line.

The maintenance of local independence and the use of the income tax to finance local expenditures is possible if shared taxes and subvention are used. However, as the local governments are responsible for a large part of the existing tax burden and are often opposed to anything that seems to weaken their position, the use of the lower bracket income tax will be most important in financing the expenditures of the states and the federal government.

As a means of increasing the degree of tax consciousness on the part of the citizens of the state and federal governments, the direct taxation of small incomes has much to commend it. However, the increase in the amount of tax consciousness that could be expected to result from the lowering of the exemptions is definitely limited and might be very small indeed if certain administrative techniques were used to avoid practical difficulties.

The strongest point in favor of the use of the direct tax on the small income is the gain in equity that could be achieved should this tax be used as an alternative to the existing levies on the small man. The complete failure of the existing tax system to meet the goals of the proper distribution of the tax burden, as conceived by the author, make him particularly favorably inclined to attempt the gradual modification of the tax system with the eventual goal of the substitution of the income tax for indirect taxes. Reservations are made in cases such as the property tax where the removal of the present tax would grant undeserved bonuses and, in other cases, where a particular tax is to be justified on grounds other than ability to pay.

Although this is not considered very important by the author, the fact should be frankly recognized that under ordinary conditions the income tax is subject to greater variation with the movements of the business cycle than many other alternative means of raising the same revenue. The majority of the students of taxation believe that, other things being equal, the better tax is the more stable tax.

If one subscribes to the view that it is desirable to maintain or increase rather than decrease government expenditures, the addi-

tional tax consciousness that may be generated by taxing small incomes may prove to be unwelcome. The irritation of tax-conscious citizens may easily result in curtailment of a favored expenditure program. However, the uncertainty of an increase in tax consciousness should be recognized.

The greatest limitation to the development of the direct taxation of the small income is believed to be the difficulties of administration. The advantages of the superior refinement of this tax can be maintained only at the cost of a rather rapidly increasing administrative burden expressed as a percentage of the revenue collected as the exemption limit is lowered. Under the conditions which prevail in the United States, this administrative problem may make it unwise to make a sharp reduction in the exemption level at the present time. If the exemptions are reduced only a little, there is, of course, the reduction in the extent to which the advantages of additional revenue, better distribution, and increased tax consciousness may be realized. Serious difficulties are found in the large area of the country and the high percentage of the population engaged in agriculture. Moreover, in the United States there has not been developed an administrative organization or an administrative personnel, either in the states or the federal government, of sufficient efficiency and competence to assure the success of a very drastic revision of the law. Although this is a problem that may be solved in time, it is not one that can be solved inside the space of a few years.

In the opinion of the writer, there is much that can be learned only by experience. It is therefore believed that the wisest policy to follow in the near future would be one of lowering the exemption under the federal income tax to a level of \$2,000 for the head of a family, \$800 for a single person, and \$300 for each dependent. If this is done, there would also be the presumption that equity would demand the repeal of existing excises of the amount of the anticipated revenue. Special effort should be expended to determine the cost of administration of the tax at this level and particular care taken to check on the amount of evasion. There might also be profitable experimentation with different techniques for the administration of the tax. As

the exemptions are lowered, there should be a special effort made to develop a trained personnel capable of dealing with the income tax assessment at lower levels.

Among the states there are now several that have exemptions that require income tax payment from the recipient of a small income. These states should make a greater effort to determine the cost of the administration of this tax at these levels without the allowance of the amount of evasion that is believed to be permitted at the present time. If different techniques were to be used in different states, there could be interesting comparisons of the success of the alternative schemes.

The essential point to be gained from the study of the possibilities of the direct taxation of the small income is that, as is the case in most phases of social policy, care must be exercised to avoid the formation of policy on the basis of inadequate or restricted consideration of the facts.



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## VITA

Paul Johnston Strayer was born in New York, N. Y., January 29, 1912.

### TRAINING:

Graduate of Horace Mann School for Boys, 1929.

A. B. Degree, Swarthmore College, 1933.

Graduate student, Columbia University, 1934 to 1937.

Seminars: "Problems of Public Finance," Professor Robert Murray Haig, "The Study of Economic Processes: Prices," Professor R. C. Mills.

M. A. Degree, Columbia University, 1935.

### POSITIONS HELD:

1933-34. Employed in Personal Trust Department, Guaranty Trust Company of New York.

Summer 1935. Research Assistant to Professor Robert Murray Haig on a study of the concept of taxable income, conducted under the auspices of the Columbia Council for Research in the Social Sciences.

Summer 1936. Member of the research staff of the Twentieth Century Fund study of current tax problems, Professor Carl Shoup, Director.

1937-38. Instructor in Economics, College of Business Administration, Lehigh University.

1938—. Instructor in Economics, Princeton University.

### ARTICLES WRITTEN:

"Possibilities of the State Personal Income Tax," *The Tax Magazine*, Vol 16, No 10, October, 1938.

"The Effect of a Rise in Prices upon the Income Tax," *Bulletin of the National Tax Association*, Vol. XXIV, No. 6, March, 1939.